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Supreme Court, U.S.
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No. 02-

IN THE

Supreme Court of the United States

JACK GREEN, INDIVIDUALLY AND AS TRUSTEE, LAWRENCE P. BELDEN, TRUSTEE, AND STANLEY SIMON, TRUSTEE,

Petitioners,

v.

FUND ASSET MANAGEMENT, L.P.; MERRILL LYNCH ASSET MANAGEMENT, L.P.; MERRILL LYNCH & CO, INC.; MERRILL LYNCH PIERCE, FENNER & SMITH INCORPORATED; PRINCETON SERVICES, INC.; ARTHUR ZEIKEL; TERRY K. GLENN; MUNIENHANCED FUND, INC.; MUNIVEST FUND II, INC.; MUNIYIELD FUND, INC.; MUNIYIELD INSURED FUND, INC.; AND UNIYIELD QUALITY FUND II, INC.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

The Investment Company Act (the "Act"), 15 U.S.C. § 80a-1 *et seq*, seeks to "mitigate and, so far as is feasible, eliminate" the operation of investment companies "in the interest of . . . investment advisers . . . rather than in the interest of . . . such companies' security holders." Section 36(b) of the Act places investment advisers under "a fiduciary duty . . . with respect to the receipt of compensation. . . ." Nonetheless, the investment advisers to leveraged, tax-exempt municipal bond funds, which utilize leverage raised by issuing senior equity to the extent of approximately thirty-five per cent of their total assets, have compensation arrangements whereby they are paid on a percentage of their funds' "net assets" including all assets attributable to the proceeds of senior equity leverage, thus making a substantial portion of their compensation dependant upon the continued utilization of leverage.

The questions presented are:

1. Whether employment, by an investment adviser to an investment company, of a compensation arrangement which provides the adviser with economic incentive and opportunity to manage the company's leverage for the maximization of its own compensation rather than for the benefit of the company's investors constitutes a violation of the adviser's fiduciary duty under Section 36(b) of the Act.

2. Whether, even if employment of such a compensation is not *per se* improper, it is a violation of the adviser's fiduciary duty to employ it in the absence of express disclosure, in the investment company's disclosure filings, of the adviser's pecuniary interest in maintaining maximum leverage.

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Petitioners respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Third Circuit in this case.

OPINIONS BELOW

The district court's opinion (per Debevoise, D.J.) denying petitioners' motion for partial summary judgment and granting respondents' motions for summary judgment (Pet.App B at pp. 10a-37a) is published at 147 F.Supp.2d 318. The court of appeals' opinion (per Ward, D.J. (sitting by designation), joined in by Scirica and Rosenn, JJ.) affirming (Pet.App. A pp. 1a-9a) is published at 286 F.3d 682. The district court's earlier opinion granting in part and denying in part respondents' motions to dismiss for failure to state a claim upon which relief can be granted (Pet.App. C pp. 39a-58a) is published at 19 F.Supp.2d 227.

STATEMENT OF JURISDICTION

The court of appeals entered its opinion and order on April 18, 2002. Petitioners invoke this Court's jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

The provisions of the Investment Company Act of 1940, 15 U.S.C. § 80a-1, *et seq.*, relevant to this petition are reprinted in the Appendix D at pp. 59a-62a.

STATEMENT OF THE CASE

1. *Introduction:* The Investment Company Act of 1940 (the "Act"), 15 U.S.C. § 80a-1, *et seq.*, declares that "the public interest is adversely affected . . . (2) when investment companies are . . . managed . . . in the interest of . . . investment advisers . . . rather than in the interest of . . . such companies' security holders" and directs that it is to be

interpreted in accordance with its policy and purposes "to mitigate and, so far as feasible, to eliminate, the condition numerated." 15 U.S.C. § 80a-1(b). In furtherance of that goal, Congress in 1979 amended the Act by adding § 36(b), 15 U.S.C. § 35(b) which provides, in relevant part that:

> The investment adviser . . . shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services. . . paid by such . . . investment company . . . to such adviser or any affiliated person.

Respondent Fund Asset Management, L.P. ("FAM"), the investment adviser to the fund respondents in this case, caused them to enter into compensation agreements with it, pursuant to which the fund respondents pay compensation to FAM on the basis of a percentage of the entire net assets of the funds, including assets attributable to the funds' preferred stock leverage. As a result, approximately one third of FAM's compensation is dependant upon maintaining the funds in a substantially fully leveraged position at all times and FAM thus has strong financial motivation to maintain leverage regardless of whether its maintenance is in the best interests of the funds' common shareholders. This compensation arrangement is fundamentally different from that employed by the advisers to most debt-leveraged investment companies, whose compensation basis excludes assets attributable to leverage from the measure of the adviser's compensation, thus leaving the adviser free of any financial interest in the employment of leverage.

The District Court and Court of Appeals, while acknowledging that Section 36(b) is not limited to "excessive fee" cases, concluded that the conflict inherent in FAM's compensation arrangement is not inconsistent with its

fiduciary duty unless, as a result of such conflict, the adviser has actually mismanaged the funds in its own interests. Pet.App. 7a-8a.

The court of appeals' decision calls for review and correction by this Court because it misconceives and emasculates the investor protection provided by Section 36(b), one of the keystone provisions by which Congress sought to require that advisers to investment companies discharge their duties with fidelity to the interests of their investor/shareholders, rather than for the adviser's own financial benefit.

First, by permitting the advisers to registered investment companies to employ compensation arrangements which create conflicting interests with respect to fund management, between the adviser and the funds' investors, the court of appeals holding invites precisely the self-interested management by advisers which § 1 of the Act declares to be contrary to the national public interest.

Second, by denying any remedy for breach of fiduciary duty in such circumstances unless investors are able to prove that the adviser deliberately mis-managed the fund for its own financial advantage, the court of appeals holding renders any remedy for self-interested management resulting from such compensation arrangements illusory.

2. *The Facts:* Petitioners are owners of common stock in the seven investment company Respondents (the "Funds"). R.3, 553. Each of the Funds was created and promoted by a corporate affiliate of FAM and several of FAM's employees served on the Funds' boards of directors. R. 1114, 1133. Each of the Funds is a registered, closed-end investment company whose common shares are publicly traded. R.3, 127-28. Each invests principally in municipal bonds exempt from

Federal income taxation. R.172. The assets of each of the Funds are leveraged by the issuance of "auction market preferred stock" which pays dividends based upon prevailing short-term interest rates and is subject to periodic re-marketing and adjustment of the dividend rate in relatively short-term cycles of between seven and twenty-eight days. R.1129. The leverage of each amounts to approximately 35% of its portfolio. R.1129.

The Funds' prospectuses recognized that the maintenance of leverage involved the risk of certain potential adverse consequences, including that

> . . . a declining market . . . would result in a greater decrease in net asset value to . . . [common stockholders] than if the Fund were not leveraged, which would likely be reflected in a greater decline in the market price for shares of Common Stock.

R.1129. Having disclosed the risks associated with the employment of leverage, the prospectuses went on to assure potential stockholders that

> In the event of an increase in short-term rates . . . to the point where the Fund's leverage could adversely affect . . . [common stockholders] as noted above, or in anticipation of such changes, the *Fund . . . may also attempt to reduce the degree to which it is leveraged* by redeeming preferred stock. . . . (emphasis supplied).

R.1130.

FAM acts as the investment advisor to the Funds and also provides them with all office space, employees and facilities needed for their operations. The Funds also pay a

fee to FAM which covers its advisory services, office space and the compensation of employees and, in addition, all their other expenses. R.1133.

FAM's fee is .5 per cent of the Funds' average weekly net assets ("NAV"). R.1133. The Funds employ senior equity, which is considered an asset for accounting purposes, rather than debt, which is considered a liability for accounting purposes, for leverage. As a result, FAM's use of a net assets measure of advisory compensation results in the inclusion of the assets attributable to leverage in the measure of its advisory compensation. As a result, some 35% of FAM's advisory compensation is dependent upon the continued maintenance of leverage.

None of the Funds' prospectuses expressly define "net asset value" or expressly state that the advisory compensation is determined on a basis which includes the leverage. They merely describe "average weekly net assets" as:

> . . . the average weekly value of the total assets of the Fund, minus the sum of accrued liabilities of the fund and accumulated dividends on the shares of preferred stock.

R.1133, 1180, 1224-5, 1267, 1319-20, 1363, 1405.

Even if that description, by itself, might be considered unambiguous, it is muddied by a further section in the prospectuses entitled "Net Asset Value" that defines "net asset value per share" as:

> . . . the value of the securities held by the Fund plus any cash or other assets . . . minus all liabilities . . . *and the aggregate liquidation value of the outstanding shares of preferred stock* . . .

> divided by the total number of shares of Common Stock outstanding. . . . (emphasis supplied)

R.1140, 1188, 1233, 1277-8, 1328, 1371, 1413.

Thus, even a reasonably careful reader of the prospectuses could easily conclude from the express exclusion of leverage from "net asset value per share" that the Funds' leverage is excluded from the measure of advisory compensation, as is ordinarily the case with respect to investment companies which use NAV and leverage with debt.

FAM's misleading reporting of its expense ratios in the Funds' annual reports reinforces any such misunderstanding. The common shareholders bear the entirety of the Funds' expenses. R.1129. Thus, the relevant measure of the Funds' expenses is the ratio of such expenses to the common stock that bears them. FAM has, nonetheless, persisted in reporting the Funds' expense ratios as a ratio of expenses to their *total* equity, *including the senior equity leverage which pays none of the expenses*. See, for example, R.1782. Since this ratio divides the Funds' expenses by a base including the senior equity, it results in artificially deflating the actual ratio of Fund expenses to assets attributable to common equity. Since the assets attributable to the senior equity represent some 35% of the Funds' entire asset base, the result is that the ratio of the Funds' expense to assets attributable to common equity were actually half again as great as the ratios presented in the annual reports FAM prepared for the Funds. R.1778, 1782. This deception is further aggravated by the presentation of "per share operating performance" immediately preceding the expense ratio data, as ratios per share of common stock

alone. *Id.*[1] Had FAM reported its expense ratio as a ratio of expense to common equity capitalization alone, that significantly higher expense ratio might have helped to alert investors to the fact that FAM's advisory fee was calculated on a base which included leverage and was thus dependant upon its maintenance.

Significantly, FAM's investment advisory agreements, which establish FAM's right to advisory compensation (and which are *not* included in the prospectuses furnished to potential investors) are far more clear and specific. The advisory agreements uniformly provide, *in addition to language echoing the language of the prospectuses*, that:

> It is understood that the liquidation preference of any outstanding preferred stock (other than accumulated dividends) *is not considered a liability in determining the Fund's average weekly net assets.*

R. 1451, 1463, 1475, 1487, 1500, 1511, 1524 (emphasis supplied).

Had the earlier language in the advisory agreements prospectuses defining "average weekly net assets" as the ". . . . value of the total assets of the Fund, minus the sum of accrued liabilities of the Fund. . . ." really been sufficient to unambiguously include the leverage in the measure of

1. While presentation of operating performance ratios on the basis of common equity alone is mandated by the SEC, the SEC never required FAM so to present its expense ratios. Indeed, the SEC eventually required investment companies to change this practice. R.1991-92. FAM took advantage of the full grace period granted by the Commission (R.1991), continuing its prior practice in the annual reports of the Funds issued for the fiscal years ending October 31, 1998, some eleven months after the SEC's policy was promulgated. R.1814 (10/31/98 report) Compare R.1817 (10/31/99 report).

advisory compensation, the additional language in FAM's contracts with the Funds would have been wholly unnecessary surplussage.

The result of FAM's compensation arrangement stands in stark contrast to that of leveraged investment companies which leverage with debt. Because debt is a liability whereas senior equity is not, investment companies that leverage with debt deduct the amount of all of the outstanding leverage in order to determine NAV. The advisory compensation paid by such companies is unaffected by changes in their utilization of leverage and their investment advisors are in a position to consider periodic adjustment in their use of leverage without such adjustment having any effect at all on the amount of advisory compensation. R.1933. Where the NAV measure of advisory compensation *excludes* the leverage (or assets attributable thereto), advisors have no financial interest of their own one way or the other in their management of leverage.

FAM represented in the prospectuses that its investment policies would be guided by principles of "prudent investment management." R.1121. FAM's senior executives, Giordano and Glenn, and two of its "disinterested" directors, West and Swensrud, all admitted that "preservation of capital" was one of the Funds' objectives as implicit in the concept of "prudent investment management." R.1733 (West), R.1696, 1711 (Swensrud), R.1574-5 (Glenn), R.1678-80 (Giordano).

FAM is required to manage the Funds in conformity with the policies disclosed in the prospectuses. R.1533. One of FAM's senior executives, a director of the Funds, acknowledged that the Funds' objectives required FAM to give primacy to "preservation of principal" (i.e. preservation

of the Funds' portfolio values) when rising interest rates were anticipated. R.1680. That was entirely consistent with the prospectuses' intimations to the same affect.

But, despite the Funds' objective of preservation of capital and the prospectuses' suggestions that FAM could avoid leveraging portfolio losses during declining market conditions by "reducing the degree to which . . . [the Funds are] leveraged by redeeming preferred stock" R. 1129-30, FAM *never once*, during the entire existence of the Funds[2], ever made, or recommended to the Funds' Boards, any reduction in the Funds' utilization of leverage. R.1652-3, 1672-77. West, one of the "disinterested" directors, confirmed that FAM had never once raised the issue of reducing leverage. R. 1740.

It was not as if no occasions for such consideration ever arose. There have been substantial periods during the existence of the Funds when interest rates rose and the portfolio values of the Funds declined. Literally tens of millions of dollars in the Funds' asset values could have been saved, during such periods, by elimination, or even reduction, of leverage. For example, during the period from the fourth quarter of 1993 through the first quarter of 1995, a period of rising interest rates, the Funds maintained their existing leverage throughout. While retention of the bonds purchased with the leverage resulted in income attributable to them of almost $78million, these earnings were offset almost threefold by losses in portfolio value of almost $164million, dividends paid on the senior equity of almost $41million and

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2. The Funds initial prospectuses are all dated between February, 1989 and March, 1993. R.1114,1159,1206,1247,1299,1343,1386.

additional advisory compensation to FAM of $6.6million for total costs of $211million. R.1625, 1630.[3]

There is a significant contrast between the performance of the Funds advised by FAM and the performance of a group of taxable debt-leveraged U.S. government bond funds examined by Petitioners' experts. While FAM did nothing to reduce the Funds' leverage (or its own advisory compensation) various taxable bond funds, which leveraged with debt and whose advisors had no financial stake in maintaining leverage, reduced leverage by some $700 million, a reduction of 34%. R.1626-7, 1631. Included in this group of debt-leveraged funds was a Merrill Lynch fund, Income Opportunities 1999, *one of two government bond funds managed by FAM*.[4] R.2009. FAM reduced these funds' use of leverage during 1994 by 17% and 20% respectively, at the same time that it made no leverage adjustments at all in its municipal bond funds, such as those at issue in this case, where such reductions would have decreased its advisory compensation. R.1627.

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3. The court of appeals opinion dismisses these circumstances by observing, correctly as far as it goes, that these losses were incurred prior to the period for which Petitioners may recover damages under § 36(b). Pet.App. 7a. The court of appeals failed to appreciate the relevance of the 1993-1995 period, and the huge losses sustained by the Funds as a result of FAM's failure to make or recommend reduction or elimination of leverage, to show that the conflict of interest inherent in its compensation arrangement is real, and not merely "potential" and that there are ample grounds to infer that FAM has been influenced, in its treatment of leverage, by its own conflicting financial interests. The relevance of this evidence to the propriety of FAM's compensation arrangement is in no way diminished by the fact that damages are not recoverable for that particular period.

4. The other FAM U.S. government bond fund was Income Opportunities Fund 2000. R.2044, 2056.

Obviously, taxable bonds differ from tax-exempt municipal bonds in that interest payments on them is subject to income taxation. But the market prices of both kinds of bonds are similarly affected by changes in prevailing interest rates and in the considerations relevant to an appropriate compensation structure for their investment advisor. R.1917-18. The prices of both vary inversely with prevailing interest rates so that when rates rise, their market price usually declines. That circumstance militates against the retention of leverage in all bond funds such periods. It is common among debt-leveraged bond funds (taxable bond funds, to be sure) that they exclude fund leverage from their measure of advisory compensation. R.1925.

FAM's reduction of leverage for the Income Opportunities funds demonstrates FAM's willingness to reduce leverage for its debt-leveraged, taxablebond funds when no reduction in its compensation results, versus its failure to reduce leverage for these Funds where reducing leverage would also have reduced its advisory compensation. It also refutes the principal rationales which FAM's experts have advanced to explain this failure as other than the result of deliberate action in its own self-interest.

FAM has claimed that any conflict of interest is irrelevant because prudent leveraging decisions cannot be made in anticipation of changes in interest rates. That consideration, if valid, applies equally to reducing leverage in taxable bond funds. The data presented by Professors Woodbury and Peterson demonstrates that no such consideration prevented the advisors to taxable bond funds, *including FAM itself*, from reducing the leveraging of such funds in 1994.

Moreover, if the future direction of interest rates is really an impenetrable mystery, it was incumbent on FAM to

disclose that to potential investors. But the Funds' prospectuses do exactly the opposite, assuring investors that:

> In the event of an increase in short-term rates or other changed market conditions . . . *or in anticipation of such changes*, the Fund . . . may also attempt to reduce the degree to which it is leveraged. . . .

R. 1133, 1176-77, 1221, 1264, 1316, 1359, 1401.

Thus, both the Prospectuses and FAM's own management of leverage in its taxable bond funds, refute FAM's present claim that future interest rates are inscrutable and demonstrate that, on the contrary, leveraging decisions can and should be made in anticipation of changing interest rates.[5]

3. *The Opinions Below.* On June 5, 2001, the district court granted Respondents' motion for summary judgment and denied Petitioner's cross motion for partial summary judgment on liability. Pet.App. 10a-35a. The district court recognized that the scope of Section 36(b) is not confined to excessive compensation claims (Pet.App. 29a) but concluded that the conflict inherent in FAM's compensation arrangement did not constitute a breach of FAM's fiduciary duty because (1) all closed-end leveraged municipal bond funds employ the same basis for calculating their fees and Congress could not have intended to condemn that industry practice in enacting Section 36(b) in 1970 (Pet.App. 30a-31a), (2) authority decided under Section 404(a)(1)(A)(i) of ERISA, 29 U.S.C. Section 1104(a)(1)(A)(I) demonstrates

5. This evidence, at least, raised a triable issue as to the credibility of FAM's claims about its inability to manage leverage in the light of changing interest rates, and thus precluded the grant of summary judgment.

that Congress did not intend to make the existence of conflicting interests a *per se* breach of statutorily created fiduciary duties (Pet.App. 31a-32a) and (3) that the funds' disinterested directors had approved the compensation arrangement (Pet.App. 32a).

On April 18, 2002 the Court of Appeals affirmed the district court's grant of summary judgment. The Court concluded that (1) the conflict of interest inherent in the challenged fee arrangement does not constitute a per se violation of FAM's fiduciary duties (Pet. App., 5a-8a) and (2) FAM adequately disclosed its compensation arrangement and thus did not breach its fiduciary duty through failing to make sufficient disclosure.

The court of appeals concluded that Section 36(b) does not proscribe "potential" conflicts of interest but rather requires that "plaintiffs allege and prove an actual breach of fiduciary duty in order to prevail in their claims" (Pet. App. 7a), i.e., that Petitioners were required to prove an "instance during the period for which they can recover damages when the advisors improperly failed to de-leverage the Funds in order to maximize their fees." Pet. App. 7a-8a. In reaching this conclusion, the court of appeals relied primarily upon legislative history of Section 36(b) indicating Congress' recognition of the conflicts of interest inherent in the determination of advisory fees and its intention to impose a fiduciary duty on advisors which would provide a remedy for breaches thereof. Pet. App. 5a-6a.

However, the court of appeals failed to recognize the distinction between the advisor's inherent and unavoidable conflict of interest in determining the *amount* of its compensation and the wholly different situation presented by fee arrangements, such as that in this case, which create a

gratuitous and avoidable conflict of interest by creating a financial incentive for the advisor to manage the funds in its own interests. Likewise, the court of appeals failed to recognize that the legislative history that it relied upon addresses the more common and predominant issue of determining the *amount* of advisory compensation and does not indicate that Congress intended to permit investment advisers to create compensation arrangements that provide gratuitous incentives to self-dealing.

The court of appeals requirement that an actual instance of self-dealing in violation of the advisor's fiduciary duty be proven is unexceptionable in cases of determination of the *amount* of advisory compensation but is unnecessary and destructive of the the Act's objectives, when applied to gratuitous conflicts such as that presented by this case. Congress plainly recognized that the advisor's conflict with respect to the determination of the amount of its compensation was both inherent and unavoidable as is the case with anyone accepting an engagement to act as a fiduciary. While the fees of trustees and executors are subject to judicial examination and approval, the law imposes no presumption that the fee charged by the fiduciary is improper. As a result, it would have been inappropriate as well as impractical to subject advisors to liability because of the mere existence of that unavoidable conflict and Congress clearly intended that the remedy for breach of fiduciary duty be limited, in such instances, to circumstances where the advisor had actually used its position of dominance to obtain an amount of compensation which was overreaching. See, S.Rep. No. 91-184 (1969), reprinted in U.S.C.C.A.N. 4897, 4901; *Gartenberg v. Merrill Lynch Asset Mgmt.*, 694 F.2d 923, 925-28 (2d Cir. 1982).

Such reasoning, however, has no application to the entirely different circumstances presented by a compensation arrangement which creates a conflicting interest not inherent in the advisor/fund relationship, which is unnecessary and easily avoidable and which establishes a financial incentive for the advisor to manage the fund for its own benefit. Such arrangements are at war with the core objective of the Act:

> to mitigate and, so far as feasible, to eliminate . . . [the management of investment companies] in the interest of . . . . advisers. . . . rather than in the interest of . . . . such companies' security holders.

15 U.S.C. Section 80a-1(b)

Thus, with regard to a compensation arrangement which provides an incentive to the advisor to maintain leverage, regardless of whether beneficial to the investors, just as with a compensation arrangement which encouraged the advisor to churn the fund's portfolio or to invest in issues which its affiliates had underwritten, there is no need to await or require proof of some instance where the incentive has actually caused the advisor to engage in intentional self- dealing. Such arrangements serve no legitimate purpose, are wholly unnecessary to the advisor/fund relationship, are invitations to self-dealing by the advisor and are facially inconsistent with its fiduciary position. Nothing in the legislative history suggests that Congress intended to permit such arrangements so long as it could not be proven that they had resulted in actual and intentional self-dealing. Indeed, such authority as there is dealing with gratuitous conflicts of interest in Section 36(b) cases is consistent with Petitioners' position.

In *Galfand v. Chestnutt Corp.*, 545 F.2d 807, 811 (2d Cir. 1976) the Second Circuit affirmed imposition of

Section 36(b) liability on an advisor that failed to disclose material facts in connection with a proposed amendment to its compensation agreement. The Court held that such failure was, in and of itself, a breach of the advisor's fiduciary duty and did not pause to consider the issue of whether the proposed amendment was itself unreasonable or overreaching.

Thus, while the lower federal courts have properly considered the inherent conflict over the *amount* of advisory compensation to be "potential" and non-actionable unless it results in compensation which is plainly overreaching (*See Gartenberg*, *supra* at 978) they have applied traditional principles of fiduciary conduct to other acts or arrangements involving avoidable conflicts of interest. *Rosenfeld v. Black*, 445 F.2d 1337 (2d Cir. 1971); *Meyer v. Oppenheimer Management Corp.*, 764 F.2d 76, 87 (2d Cir. 1985).

The court of appeals also concluded that FAM's disclosure of its compensation arrangement was adequate, ignoring both the prospectuses' exclusion of leverage from its definition of "net asset value per share" and their misleading understatement of the funds' expense ratios. Pet. App. 8a-9a.

This petition for a writ of certiorari followed.

REASONS FOR GRANTING THE WRIT

The petition should be granted for two reasons.

First, the Third Circuit's Judgment is irreconcilable with the fundamental purposes of both the Act as a whole, and Section 36(b) in particular and permits and, indeed, invites advisory compensation arrangements which have no purpose or affect other than to encourage self-interested management of investment companies by their advisors; one of the evils

expressly identified by Section 1(b) of the Act, which the Act seeks to eliminate insofar as possible. 15 U.S.C. Section 80a-1(b), Pet. App. 59a-60a.

Second, the Third Circuit's requirement that petitioners prove an actual instance, within the damage period, when FAM deliberately mismanaged the funds for its own advantage, renders illusory even the limited remedy which that Court recognized.

1. The Decision Below is Inconsistent with the Fundamental Values and Purposes of the both the Investment Company Act and Section 36(b) thereof.

This case comes squarely within Rule 10(c) of this Court's Rules as a case that calls for the exercise of the Court's discretion to review when:

> . . . a . . . court of appeals has decided an important question of federal law that has not been, but should be, settled by this Court. . . .

With a large and growing portion of the Nation's capital, including its citizens' pension and retirement savings, invested through investments in registered investment companies, and with public confidence in the integrity of the financial markets fragile at best, there can be little doubt that the public interest in achieving the Investment Company Act's objectives, including the objective of mitigating and, so far as feasible, eliminating the management of investment companies by their advisors for their own benefit and at the expense of the investors is, if anything, greater than it was either when Congress originally promulgated the Act in 1940 or when it amended it by adding the provisions of Section 36(b) in 1970.

Congress enacted a series of provisions to achieve the Act's purposes, prohibiting some transactions between investment companies and their advisors entirely, requiring that investment company boards have substantial proportions of directors who are not affiliated with the adviser, regulating the capital structure of investment companies and prohibiting breaches of their fiduciary duties by investment advisors. These provisions are part of a regulatory structure, each provision of which was intended by Congress to contribute to achieving the Act's ultimate objective that registered investment companies be managed honestly and in the interests of the investors, rather than to benefit the financial services enterprises that create them, sell investments in them to the public and derive their continuing revenues from the fees paid by the investors for the provision of investment advisory and management services. The provisions of the Act are intended to work together to promote those ends and no single provision is to be disregarded or left un-enforced merely because other provisions of the Act may also have application to the circumstances of some particular abuse.

The Act was enacted to eliminate the abuses that Congress perceived in the industry. *S.E.C. v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186, 84 S.Ct. 275, 280 (1963) and to address the SEC's findings that:

> Investment advisers could not 'completely perform their basic function . . . furnishing to clients on a personal basis competent, unbiased, and continuous advise regarding the sound management of their investments ...unless all conflicts of interest between the investment counsel and the client were removed.'

Investment Trusts and Investment Companies, Report of the Securities and Exchange Commission, Pursuant to Section 30 of the Public Utility Holding Company Act of 1935, On Investment Counsel, Investment Management, Investment Supervisory and Investment Advisory Services, H.R. Doc. No. 477, 76th Cong.2d Sess. 1 (hereinafter "SEC Report").

Section 36 of the Act, as originally enacted, provided a remedy for "gross abuse of trust" by advisers but a further study of the investment company industry concluded that that section was not effective in providing sufficient protection to investment company shareholders. Wharton School of Finance and Commerce, A Study of Mutual Funds, H.R.Rep. No. 2274, 87th Cong. 2d Sess. (1962). This led to the enactment of the Investment Company Amendments Act of 1970 which, *inter alia*, modified original Section 36 (and, as amended, made it Section 36(a)) by prohibiting breaches of trust involving "personal misconduct" and by adding Section 36(b) which placed the advisor under a fiduciary duty with respect to the receipt of compensation.

Congress could, of course, have simply prohibited advisers from receiving excessive compensation or required that their compensation be no more than "reasonable" but despite early versions of the amendment to the latter effect, it did not do so. Instead, it created an obviously broader requirement by imposing on advisers "a fiduciary duty with respect to the receipt of compensation for services." It thus made the adviser a fiduciary with respect to its compensation arrangements and prohibited arrangements that are inconsistent with that fiduciary duty.

Just as the SEC Report had found, even before the enactment of the original Act in 1940, that the removal of

"all conflicts of interest" was necessary to ensure that advisors would properly perform their duties, so it is at the core of fiduciary responsibilities generally that fiduciaries must avoid any avoidable circumstances which create interests for them which conflict with their fiduciary responsibilities and which might incline them to further their own interests at the expense of their beneficiaries. That is the very basis of the "rule of undivided loyalty" for trustees. Scott on Trusts, 4th Ed., Section 170.15, *accord*, Bogart on Trusts, 3d Ed., Sec. 543 at pp. 475-76:

> Reasons behind the establishment of the loyalty rule by equity are that
>
> it is generally, if not always, humanly impossible for the same person to act fairly in two capacities and on behalf of two interests in the same transaction. Consciously or unconsciously he will favor one side as against the other, where there is or may be a conflict of interest. If one of the interests involved is that of the trustee personally, selfishness is apt to lead him to give himself an advantage.

It is daunting to conceive of an area where an advisor may be more strongly or directly tempted to serve its own interests than with respect to the arrangement by which it receives compensation for its services. While the advisor's conflict with respect to the amount of its compensation is inherent in the relationship and thus unavoidable, it does not follow that all possible conflicts of interest created by an advisor's compensation arrangement are similarly inherent and unavoidable or that they must be tolerated except when they lead to actual intentional self-dealing. The record before the district court on the motions for summary judgment

clearly showed that many debt-leveraged investment companies compensated their advisors on a basis which entirely excluded leverage or its proceeds from the measure of advisory compensation and which thus left such advisors with no financial stake at all in the management of leverage. The commonly used "net asset value" ("NAV") measure of advisory compensation has precisely that effect in the case of debt-leveraged funds because debt is a liability excluded deducted from assets in order to arrive at "net assets." The record established no circumstance unique or peculiar to leveraged municipal bond funds, which requires that their advisors' compensation be calculated on a basis which includes leverage. The conflict inherent in FAM's compensation arrangement was thus shown to be entirely unnecessary. It serves no purpose other than as a circumstance providing substantial motivation to FAM to manage the leverage of the funds with primary attention to its own financial interests.

The Court of Appeals Judgment approving this arrangement simply invites self-dealing by advisers who opt to include leverage in the measure of their advisory compensation. Such arrangements are inimical to the Act's objective of eliminating, to the extent possible, the occasions for self-dealing by investment company advisors and the Court of Appeals Judgment thus warrants review and correction by this Court in order to preserve the Act's effectiveness and vindicate its policies.

2. The Court of Appeals' Requirement that Deliberate Mismanagement by the Advisor for its own Financial Advantage be Pleaded and Proven Renders Any Remedy for an Advisor's Self-Dealing with Respect to Leverage Management Illusory.

The Court of Appeals concluded not only that FAM's compensation arrangement was not a *per se* breach of its fiduciary duty, but that the funds' investors could maintain no claim unless they could demonstrate some instance, within the damage period, when FAM "improperly failed to de-leverage the Funds in order to maximize their fees. . . ." Pet.App. 7a-8a. That requirement effectively insulates advisors such as FAM, which elect to receive their advisory compensation on a basis which includes fund leverage, from any liability even when they, in fact, manage leverage to advance their own financial interests and are heedless of the interests of the investors.

Section 36(b)(1) places upon plaintiffs the burden of proving a breach of fiduciary duty by the advisor. If a breach can only be established by proof that the adviser intentionally mismanaged the fund's leverage for the purpose of maximizing its own fees, then plaintiffs have an impossible burden of proving not only the state of the advisor's knowledge and awareness with respect to the likely future movement of interest rates, but also with respect to the advisor's subjective motivation for its actions or recommendations. Investors can prove neither since both are matters peculiarly within the knowledge of the advisor and the advisor is unlikely to candidly acknowledge either its belief that the financial circumstances militated in favor of reducing leverage or its motivation to ignore such circumstances in order to serve its own interests. As a result, the *only* potentially effective remedy is to proscribe

compensation arrangements which provide the occasion and motivation for such self-dealing.

The record before the district court was replete with evidence which demonstrated the futility of any attempt to prove FAM's actual belief, at any time, in the existence of circumstances which militated in favor or reducing leverage, much less to establish FAM's venially motivated maintenance of leverage in disregard of same. While FAM clearly acknowledged in the prospectuses that circumstances could exist in which it could anticipate increasing interest rates and in which it thus might be appropriate to reduce the funds' leverage (R. 1130), FAM's officers and managers and retained experts firmly maintained that, despite the statements in the prospectuses, the future movement of interest rates was not sufficiently predictable to serve as a basis for prudent leverage management decisions and, moreover, that even if the increases in interest rates that actually occurred during 1994 had been predictable, anticipation of such increases would not have justified reducing the funds' leverage because they thought that it was more important to preserve without reduction comparatively small amounts of tax exempt income from bond interest payments than to avoid market losses in portfolio value of several times the amount of tax exempt income preserved.

Moreover, it was undisputed that the leverage management decisions are matters of judgment, about which reasonable and informed opinions can differ. Because it is virtually impossible to refute the merits, much less the subjective sincerity, of an advisor's professed opinions about such matters of judgment, it is all the more important that the advisor, who determines or strongly influences such decisions, have no personal interest in their resolution and be in a position to exercise a truly disinterested judgment.

In this case, no evidence could have been adduced to refute the beliefs which FAM's employees maintained they held or the sincerity of their claimed value judgment as to the comparative costs and benefits of maintaining a fully leveraged position in a declining bond market. Moreover, a fact finder's mere disbelief in the credibility of their testimony would not have constituted evidence to the contrary or served to satisfy Petitioners' burden of proving a breach of FAM's fiduciary duties.

It follows that a remedy for breach of the advisor's fiduciary duty that requires proof that the advisor (1) actually believed that de-leveraging was the best course for the funds and (2) declined to reduce leverage with the purpose of maintaining its own compensation is, in reality, no remedy at all. The advisor, unless it admits to its own wrongdoing, can always maintain that it did not believe that circumstances warranted reducing leverage and that, regardless, its actions were motivated by its own subjective conclusion that any benefits from reducing leverage would be outweighed by its disadvantages. In such event, the advisor will be entitled to summary judgment because plaintiffs will be unable to adduce affirmative evidence to the contrary. That was the burden that the Court of Appeals Judgment imposed upon Petitioners here. In this respect as well, the Court of Appeals' Judgment warrants review and correction by this Court in order to prevent the subversion and defeat of the Act's objective of preventing self-dealing by investment advisors.

CONCLUSION

For the reasons above set forth, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT DATED AND FILED APRIL 18, 2002

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 01-2736

JACK GREEN, Individually and as Trustee;
LAWRENCE P. BELDEN, Trustee;
STANLEY SIMON, Trustee,

v.

FUND ASSET MANAGEMENT, L.P.;
MERRILL LYNCH ASSET MANAGEMENT, L.P.;
MERRILL LYNCH & CO., INC.;
MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.;
PRINCETON SERVICES, INC.; ARTHUR ZEIKEL;
TERRY K. GLENN; MUNIENHANCED FUND, INC.;
MUNIVEST FUND II, INC.; MUNIYIELD FUND, INC.;
MUNIYIELD INSURED FUND, INC.;
MUNIYIELD INSURED FUND II, INC.;
MUNIYIELD QUALITY FUND, INC.;
MUNIYIELD QUALITY FUND II, INC.,

Jack Green,
Lawrence P. Belden,
Stanley Simon,
Appellants.

Argued: March 4, 2002

Appendix A

Before: SCIRICA and ROSENN, *Circuit Judges*, and WARD, *District Judge*[*]

(Filed: April 18, 2002)

OPINION OF THE COURT

WARD, *District Judge.*

This is an appeal from the district court's grant of summary judgment for defendants on claims that investment advisors to municipal bond funds breached their fiduciary duties under § 36(b) of the Investment Company Act of 1940 ("ICA") and state law. Because we conclude that plaintiffs have failed to allege any conduct constituting a breach of fiduciary duty by the investment advisors, we affirm the judgment of the district court.

I. Background[1]

Plaintiffs, shareholders in seven closed-end, publicly-traded municipal investment funds (the "Funds"), brought suit against the Funds and their investment advisors, Fund

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* The Honorable Robert J. Ward, United States District Judge for the Southern District of New York, sitting by designation.

1. Because the factual background and procedural history of this case have been set forth in great detail in three previous opinions, *see Green v. Fund Asset Mgmt.*, 19 F. Supp. 2d 227 (D.N.J. 1998) ("Green I"); 245 F.3d 214 (3d Cir. 2001) ("Green II"); 147 F. Supp. 2d 318 (D.N.J. 2001) ("Green III"), only those facts necessary to the disposition of the instant appeal are set forth here.

Appendix A

Asset Management, L.P. ("FAM") and Merrill Lynch Asset Management, L.P. ("MLAM"), claiming that defendants had violated their fiduciary duties under the ICA and state law.

The Funds at issue invest in long-term, tax-exempt municipal bonds. In order to increase the overall yield to shareholders, the Funds' advisors seek to maximize the number of high-yield, long-term bonds in the Funds' portfolios through the use of leverage. The advisors raise capital to buy additional long-term bonds by selling shares of preferred stock. Investors who buy preferred stock receive tax-exempt monthly dividends based on short-term interest rates, typically two and one-half to four percent. Because the long- term investments purchased by the Funds with the proceeds from the sale of preferred shares normally pay higher rates of return than the Funds are obligated to pay to preferred shareholders, the yield to common shareholders is increased. All of the tasks associated with the sale of preferred stock as well as the overall management of the Funds are handled by FAM and MLAM. For their services, FAM and MLAM receive an advisory fee of one-half of one percent of the Funds' average weekly net assets.

Plaintiffs here do not allege that the advisors' compensation was excessive; rather, they allege that because the bonds purchased with the proceeds from the sale of preferred shares are included in the corpus of assets upon which the advisory fee is based, FAM and MLAM have a strong financial incentive to keep the Funds fully leveraged. This incentive, they maintain, creates an actual conflict of interest between the Funds and their advisors that amounts to a *per se* breach of fiduciary duty under § 36(b). Secondly,

plaintiffs allege that the advisors' failure to disclose this conflict of interest adequately in the Funds' prospectuses is a separate actionable breach of fiduciary duty.

Defendants moved for summary judgment on plaintiffs' § 36(b) claims,[2] contending that a potential conflict of interest in the calculation of fees does not amount to an actionable breach of fiduciary duty under § 36(b) of the ICA and that the method of calculating advisory fees was fully disclosed in the Funds' prospectuses. The district court granted defendants' motion for summary judgment on June 5, 2001, holding that (1) plaintiffs' claims against the Funds' officers were not cognizable under § 36(b) because the officers were not the recipients of the advisory fees;[3] (2) the disclosure of the fee arrangement in the Funds' prospectuses was "nose-face plain;" and (3) the conflict of interest inherent in the fee structure did not constitute a *per se* breach of fiduciary duty by the Funds' advisors. *See Green III*, 147 F. Supp. 2d 318 (D.N.J. 2001). Because the court determined that, even if true, plaintiffs' allegations did not establish a violation of § 36(b), the court entered summary judgment for defendants. This appeal followed.

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2. Plaintiffs' original complaint asserted claims under § § 8(e), 34(b), and 36(a) as well as § 36(b) of the ICA and state law. On February 23, 1998, the § § 8(e), 34(b), and 36(a) claims were dismissed. Plaintiffs then filed an amended complaint, and defendants moved for judgment on the pleadings on the grounds that the state law claims were pre-empted by federal law. The district court granted defendants' motion, but the decision was reversed by this Court in *Green II*, 245 F.3d 214 (3d Cir. 2001), and the state law claims reinstated. Defendants subsequently filed the motion for summary judgment that is the subject of this appeal.

3. Plaintiffs have not appealed from the portion of the judgment dismissing the claims against the Funds' officers.

II. Discussion

We review the district court's decision *de novo*. *Schnall v. Amboy Nat'l. Bank*, 279 F.3d 205, 208 (3d Cir. 2002). Our initial task is to determine whether the district court erred in ruling that a fee arrangement in which a fund's investment advisors have an incentive to maximize leverage in order to increase their advisory fees is not a per se breach of an investment advisor's fiduciary duties under § 36(b) of the ICA. We conclude that the legislative history and the text of § 36(b) make clear that potential conflicts of interest in mutual fund fee arrangements are not *per se* violations of investment advisors' fiduciary duties; an actual breach must be alleged and proven.

Section 36(b) of the ICA provides that investment company advisors owe shareholders in investment companies a fiduciary duty with respect to determining and receiving their advisory fees. 15 U.S.C. § 80a-35(b) (1997). The legislative history of the section indicates that Congress recognized the conflicts of interest inherent in mutual fund fee arrangements — indeed, this was the impetus for enacting § 36(b). The Senate Report accompanying § 36(b) noted that "[s]ince a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter, sever its relationship with the adviser." S. REP. No. 91-184 (1969), *reprinted in* 1970 U.S.S.C.A.N. 4897, 4901. The report also stated that "in view of the *potential conflicts of interest* involved in the setting of these fees, there should be effective means for the courts to act where mutual fund shareholders

or the SEC believe there *has been a breach* of fiduciary duty." *Id.* at 4898 (emphasis added). Section 36(b), Congress believed, "provides an effective method whereby the courts can determine *whether* there has been a breach of this duty by the adviser." *Id.* (emphasis added.)

The text of § 36(b) lends further support to the district court's conclusion that § 36(b) was intended to provide a very specific, narrow federal remedy that is more limited than the common law doctrines on which plaintiffs primarily rely. *See Green III*, 147 F. Supp. 2d at 329 (citing *Verkouteren v. Blackrock Fin. Mgmt., Inc.*, 37 F. Supp. 2d 256, 261 (S.D.N.Y. 1999)); *see also* S. REP. No. 91-184 (1969), *reprinted in* 1970 U.S.S.C.A.N. 4897, 4898 & 4903 ("[T]he unique structure of mutual funds has made it difficult for the courts to apply traditional fiduciary duty standards in considering questions concerning management fees," and § 36(b) was designed "to provide a means by which the Federal courts can effectively enforce the *federally-created fiduciary duty* with respect to management compensation.") (emphasis added).

The fact that the fiduciary duty imposed by § 36(b) is significantly more circumscribed than common law fiduciary duty doctrines is demonstrated by § 36(b)'s limitations on recovery: under § 36(b), a shareholder may only sue the recipient of the fees; recovery is limited to *actual* damages resulting from the breach; and damages are not recoverable for any period prior to one year before the action was instituted, in this case before June 21, 1995. 15 U.S.C. § 80a-35(b)(3). Further, the plaintiff has the burden of proving a breach of fiduciary duty, *id.* at § 80a-35(b)(1), in

contrast with the common law rule that requires a fiduciary to justify its conduct. *See, e.g., Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 528 F. Supp. 1038, 1044 n.6 (S.D.N.Y. 1981), *aff'd*, 694 F.2d 923 (2d Cir. 1982) ("At common law it was incumbent on the fiduciary to justify his transaction with his cestui. Under this statute [§ 36(b)] the burden is reversed.").

In addition, the independent directors of the Funds testified that they were fully aware that fees were to be paid on assets acquired through leverage and that they reviewed and approved the advisory fee agreements each year. (Swensrud Tr. at 117; West Tr. at 101-02.) The district court took this into account, as Congress directed; according to § 36(b), approval of the management fee by the directors "shall be given such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. § 80a-35(b)(2); *see Green III* at 332.

Our interpretation of both the text and legislative history of § 36(b) mandates that plaintiffs allege and prove an actual breach of fiduciary duty in order to prevail on their claims. Because plaintiffs have not pointed to any instance during the period for which they can recover damages[4] when the

4. Plaintiffs claim the advisors made an incorrect leveraging decision during the period extending from fourth quarter 1993 to first quarter 1995; however, plaintiffs concede that they cannot recover damages for this period. The statute prohibits recovery of damages for any period prior to one year before the action was instituted. Since this action was filed on June 21, 1996, plaintiffs cannot recover damages for any breach occurring before June 21, 1995. Moreover, plaintiffs did not invest in the Funds until May 1995.

advisors improperly failed to de-leverage the Funds in order to maximize their fees and because plaintiffs have not alleged any actual damages they or the Funds suffered as a result of any improper decision by the Funds' investment advisors, they do not have a cognizable claim under § 36(b). *Accord Krantz v. Prudential Invs. Fund Mgmt. LLC*, 77 F. Supp. 2d 559, 563-65 (D.N.J. 1999) (holding that where plaintiff did not allege any injury resulting from the approval of investment advisory agreements by fund directors who were allegedly "interested" in the fund's advisor, plaintiff's "conclusion that a fiduciary breach [under § 36(b)] necessarily flows from the invalid [a]greements must therefore fail.").

Likewise, we conclude that the district court was correct in ruling that defendants adequately disclosed the method by which advisory fees would be calculated. First, the fact that advisory fees would be calculated based on the total assets of the Funds, including assets acquired through the use of leverage, was fully disclosed in the Funds' prospectuses: the definition of "average weekly net assets" makes perfectly plain that *all* assets of the fund, including those bonds purchased with the proceeds of preferred stock sales, are taken into account in calculating the advisory fee. Each prospectus states that the advisors will receive a monthly advisory fee of one-half of one percent of the fund's "average weekly net assets." MuniEnhanced Fund Prospectus at 20.[5] "Average weekly net assets" is defined as "the average weekly value of the *total* assets of the Fund, minus the sum of accrued liabilities of the Fund and accumulated dividends

5. The prospectuses for the six other funds contain identical disclosures.

on the shares of preferred stock." *Id.* (emphasis added). Indeed, lead plaintiff Jack Green testified at his deposition that he became aware of the conflict of interest that led him to bring the instant lawsuit by reading the prospectuses. (Green Tr. at 58-59.) If Mr. Green was able to correctly ascertain the method by which the fees would be calculated from public filings, the logical conclusion is that the method was adequately disclosed. Therefore, because the information needed to determine the method of calculating advisory fees was clearly available to and understood by shareholders, the district court properly dismissed plaintiffs' claim that defendants failed adequately to disclose the basis of their fees.

III. Conclusion

Because we find that plaintiffs have failed to present sufficient evidence to create a genuine issue of material fact regarding whether the Funds' investment advisors breached their fiduciary duties under § 36(b) of the ICA, we affirm the judgment of the district court.

A True Copy:
Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

APPENDIX B — OPINION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF NEW JERSEY DATED AND FILED JUNE 5, 2001

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

C.A. No. 97-3502 (DRD)

JACK GREEN, Individually and as Trustee,
LAWRENCE P. BELDEN, Trustee, and
STANLEY SIMON, Trustee,

Plaintiffs,

v.

FUND ASSET MANAGEMENT, L.P.,
MERRILL LYNCH ASSET MANAGEMENT, L.P.,
MERRILL LYNCH & CO., INC.,
MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,
PRINCETON SERVICES, INC., ARTHUR ZEIKEL,
TERRY K. GLENN, MUNIENHANCED FUND, INC.,
MUNIVEST FUND II, INC., MUNIYIELD FUND, INC.,
MUNIYIELD INSURED FUND, INC.,
MUNIYIELD INSURED FUND II, INC.,
MUNIYIELD QUALITY FUND, INC., and
MUNIYIELD QUALITY FUND II, INC.,

Defendants.

OPINION

DEBEVOISE, Senior District Judge.

This matter is before the court on defendants' motions for summary judgment and on plaintiffs' cross-motion for

partial summary judgment on liability. For the reasons that follow, the plaintiffs' cross-motion shall be denied, the defendants' motions for summary judgment shall be granted, and the case shall be dismissed.

FACTUAL BACKGROUND AND PROCEDURAL HISTORY

Plaintiffs commenced this action by filing their original complaint on June 21, 1996 in the United States District Court for the District of Massachusetts. On July 18, 1997, the action was transferred to this court. In their original complaint, plaintiffs lodged against the defendants federal statutory claims under sections 8(e), 34(b), 36(a), and 36(b) of the Investment Company Act of 1940 (the "ICA"), and state common-law claims for breach of fiduciary duty and deceit. On February 23, 1998, on defendants' motion, plaintiffs' claims under sections 8(e), 34(b), and 36(a) of the ICA were dismissed, leaving only their claim under section 36(b) of the ICA. *See Green v. Fund Asset Mgmt., L.P.*, 19 F. Supp. 2d 227 (D.N.J. 1998) ("*Green*"). In the wake of this disposition, plaintiffs filed an amended complaint, without leave of court, on March 31, 1998.[1]

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1. Though plaintiffs did not obtain leave of court or the defendants' written consent prior to filing their amended complaint, as required by Rule 15(a) of the Federal Rules of Civil Procedure, defendants have answered the amended complaint, and both defendants and plaintiffs have moved for summary judgment on the section 36(b) claim set forth therein. The amended complaint shall therefore be considered to have been properly filed and to be operative.

Appendix B

On June 14, 1999, on defendants' motion for judgment on the pleadings, plaintiffs' state-law claims were dismissed on the ground that they were preempted by section 36(b) of the ICA. *See Green v. Fund Asset Mgmt., L.P.*, 53 F. Supp. 2d 723 (D.N.J. 1999). On March 16, 2001, this judgment was reversed; the state-law claims were reinstated, and the matter was remanded for further proceedings. *See Green v. Fund Asset Mgmt., L.P.*, 245 F.3d 214 (3rd Cir. 2001).

Defendants have now moved for summary judgment on plaintiffs' remaining federal claim under section 36(b) of the ICA, 15 U.S.C. § 80a-35(b) (1940, as amended). Plaintiffs have filed a cross-motion on this claim for partial summary judgment on liability. The state-law claims are not the subject of the instant motions.

As the factual background and procedural history of this case are set forth in *Green*, only those undisputed facts and disputed factual allegations necessary to disposition of these motions shall be recited here. All recitations of fact are undisputed unless otherwise noted.

Purpose and Operation of the Funds

Plaintiffs own common stock in the seven defendant non-diversified, closed-end management investment companies (the "funds"). The funds are non-diversified in that their investment assets consist largely, if not entirely, of "obligations issued by or on behalf of states, territories and possessions of the United States and their political subdivisions, agencies or instrumentalities paying interest which, in the opinion of bond counsel to the issuer, is exempt

from federal income taxes ('municipal bonds')." Prospectus, MuniVest Fund II, Inc., 3/19/93, Exhibit B to Declaration of Sean M. Murphy in Support of Defendants' Motions for Summary Judgment, at 10 (initial capitals changed to lowercase).[2] The funds are closed-end in that they do not redeem their securities at the option of their shareholders, and do not engage in continuous stock offerings. Prospectus at 9. The funds are registered under the ICA. *Ibid.* Each fund's goal is providing "shareholders with as high a level of current income exempt from federal income taxes as is consistent with its investment policies and prudent investment management." *Id.* at 10; *accord* Am. Compl. ¶ 31, at 9.

An essential feature of the funds' operation is leverage. Ordinarily, the term "leveraged" is used to describe investments made with a given amount of capital and a given amount (often a larger amount) of borrowed funds. *See* BLACK'S LAW DICTIONARY 906 (6th ed.1990). However, leverage is also used to describe "[t]he effect on common stockholders of the requirements to pay bond interest and preferred stock dividends before payment of common stock dividends," *ibid.*, and it is in this connection that the term is used to describe the funds' operation.

Common stockholders in the funds have provided the main corpus of capital with which the funds have purchased long-term municipal bonds for their portfolios. In lieu of

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2. The MuniVest Fund II prospectus is an exemplar; the parties do not dispute that the prospectuses for the other six funds contain provisions identical or equivalent, in all material respects, to the provisions of the MuniVest Fund II prospectus. *See* Defs.' Resp. Pls.' Statement Undisputed Material Facts ¶ 62, at 28; ¶¶ 66-67, at 30-31.

borrowing funds at standard market interest rates, ranging typically from six to eight percent (6%-8%), in order to purchase additional municipal bonds, the funds have issued shares of preferred stock that pay, on a monthly basis, dividends at rates equal to short-term interest rates, ranging typically from two and one-half to four percent (2 1/2 %-4%). Investors are willing to purchase preferred stock paying such low dividend rates chiefly because the funds' asset portfolios consist in the main of municipal bonds exempt from federal income taxation, and so the preferred stock dividends are also exempt from federal income taxation. Defs.' Statement Undisputed Material Facts ¶ 34, at 8.[3] The funds have used the proceeds from their issues of preferred stock, purchased by investors, to purchase additional municipal bonds.[4]

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3. However, as defendants' counsel explained at oral argument, such investors generally do not want to make such investments in the long term at such low (albeit federally tax-free) interest rates. Thus, the funds oversee weekly auctions at which those wishing to buy, sell, or hold onto shares of preferred stock in the funds bid on the dividend rates for the coming week. These weekly auctions allow the funds to pay dividends to preferred shareholders at the lowest prevailing market interest rates, which, as will be seen, maximizes the yield to common shareholders in the funds.

4. In their briefs and at oral argument, plaintiffs' counsel used loose terminology demonstrating considerable confusion about the funds' operation and basic accounting principles. It is appropriate to dispel this confusion at this point.

Plaintiffs repeatedly refer only to the municipal bonds purchased with the proceeds from issues of preferred stock as "leverage" or

(Cont'd)

Appendix B

The use of leverage furthers the funds' stated goal of providing investors with income exempt from federal income taxation. Under normal market conditions, securities with longer maturities, such as these long-term municipal bonds, produce higher yields than do short-term securities, such as the preferred stock. The spread between the dividend rates payable on the preferred stock and the coupon rates on the long-term municipal bonds provides common shareholders with a higher yield than they would have realized had the funds not been leveraged with issues of preferred stock. Prospectus, Ex. B. to Murphy Decl., at 17.

As the funds have made abundantly clear to potential investors, leverage, like investment itself, has its risks. The funds are non-diversified: the vast majority of the funds' assets consists of large positions taken in the municipal bonds

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(Cont'd)

"leveraged assets." This is inaccurate. Leverage is an investment tool, not a category of assets. All of the assets in the funds' portfolios, including municipal bonds purchased with the proceeds from issues of preferred stock, are leveraged.

Plaintiffs repeatedly treat the preferred stock and the assets purchased with the proceeds from issues of preferred stock as one and the same. This violates basic principles of accounting. Shares of preferred stock are assets of the stockholders, not of the funds.

Plaintiffs repeatedly urge that the funds' obligations to preferred stockholders should be treated as liabilities of the funds. This is at odds with generally accepted accounting principles, according to which the funds carry their obligations on preferred stock on their books as capital, not as liabilities. Defs.' Statement Undisputed Material Facts ¶ 42, at 10.

of a small number of issuers. *See* Prospectus at 12 (explaining non-diversified status under the ICA and the Internal Revenue Code). The municipal bonds are long-term, fixed-coupon instruments; accordingly, they pay interest periodically to investors at a fixed percentage of the principal amount, and then yield the principal upon maturity. For this reason, if long-term interest rates rise above the municipal bonds' fixed-coupon rates, the market value of the bonds decreases, and the bonds trade at a discount. When this happens, the impact of the reduction in the bonds' market value is felt more acutely by the common shareholders than if the funds held a smaller dollar amount in bonds or if the funds' asset portfolios were more diversified. Prospectus at 17, 18. This results in a corresponding reduction in the net asset value, with a likely reduction in market value, of the common stock. *Id.* at 18.

If short-term interest rates rise more steeply than do long-term interest rates, the positive yield curve created by the spread between short-term and long-term rates flattens; if short-term rates exceed long-term rates, the yield curve becomes inverted. In this case, this means that as short-term interest rates rise relative to long-term interest rates, the dividend rate paid on the outstanding shares of preferred stock increases, while the fixed-coupon rate on the bonds remains the same. As the yield curve flattens, the benefit of leverage reflected in the return to common shareholders is reduced. *Ibid.* If short-term rates exceed long-term rates — if the dividend rate paid on the preferred stock exceeds the fixed-coupon rate on the bonds — then the inverted yield curve results in a lower rate of return to the common shareholders than if the funds had not been leveraged. *Ibid.*

Appendix B

The prospectus defines net asset value per share of common stock in a fund as the value of the securities held by the fund, plus any cash or other assets, including interest accrued but not yet received, minus all liabilities, including accrued expenses, and the aggregate liquidation value of the outstanding shares of preferred stock, all divided by the total number of outstanding shares of common stock. Prospectus at 30. By contrast, the prospectus defines net asset value per share of preferred stock in a fund as the original purchase price per share plus accumulated dividends per share. *Id.* at 31. The common shareholders pay all costs and fees associated with managing the funds, including the costs associated with the issuance of preferred stock and its weekly auctioning on the secondary market. *Id.* at 18; *accord* Am. Compl. ¶ 68, at 21. Further, the funds will declare a dividend to common shareholders if and only if all accumulated preferred stock dividends have been paid. *Id.* at 24. These hierarchical distinctions between preferred and common stock accentuate the impact of reductions in the market value of the municipal bonds.

Advisory Compensation Agreements

The funds are managed by defendant investment advisors Fund Asset Management, L.P. and Merrill Lynch Asset Management, L.P. (collectively, "the advisors"). The prospectus specifies that the funds will pay the advisors for their investment management services a monthly fee of one-half of one percent (0.50%) of the funds' average weekly net assets. Prospectus at 22; *accord* Am. Compl. ¶ 37, at 11. "Average weekly net assets" are defined in the prospectus as "the average weekly value of the **total assets of the fund,**

minus the sum of accrued liabilities of the fund and accumulated dividends on the shares of preferred stock." *Ibid.* (initial capital omitted, emphasis added). In at least one of the investment advisory agreements struck between the funds and the advisors (all of which agreements are on file with the Securities and Exchange Commission), "average weekly net assets" are further defined by exclusion: "[i]t is understood that the liquidation preference of any outstanding preferred stock (other than accumulated dividends) is not considered a liability in determining the fund's average weekly net assets." Investment Advisory Agreement between Munivest Fund II, Inc. and Fund Asset Management, Inc., 3/17/93, Ex. C to Murphy Decl., at 7. This is in keeping with generally accepted accounting principles. *See supra* note 4.

It is worth noting at this juncture the key accounting distinction between the funds' assets and their capital. As noted above, *see supra* page 8, the net asset value per share of common stock in the funds equals the funds' assets minus the sum of their liabilities and the aggregate liquidation value of the outstanding shares of preferred stock. This is the common shareholders' equity in the funds; this is also part of the funds' investment capital. *See* Annual Report of Munivest Fund II, Inc. for Fiscal Year Ending October 31, 1994, Statement of Assets, Liabilities and Capital, Ex. D to Murphy Decl., at 10. By contrast, the net assets of the funds, upon which the advisors' fee is calculated, equal the funds' assets minus the sum of the funds' accrued liabilities and the accumulated dividends on shares of preferred stock. *See ibid.*

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DISCUSSION

The plaintiffs have plethorically briefed a welter of issues and advanced many arguments, but their case under section 36(b) of the ICA boils down to two claims: (i) the funds failed adequately to disclose that the municipal bonds purchased with the proceeds from the issuance of preferred stock are taken into account in determining the advisors' fees; and (ii) the advisors have taken their fees in the face of a conflict between their interests and the funds' that amounts per se to a breach of fiduciary duty. Neither of these claims has merit.

Section 36(b) of the ICA

In 1970, Congress recognized that the interests of investment company advisors whose fees are based upon the quantum of assets in their advisee investment companies' portfolios are in potential conflict with the interests of those investment companies. S.REP.NO. 91-184 (1970), *reprinted in* 1970 USSCAN 4897, 4898.[5] With this in mind, Congress enacted section 36(b) of the ICA.

Section 36(b) makes it clear, "as a matter of Federal law," that investment company advisors owe shareholders in investment companies a fiduciary duty in determining and receiving their advisory fees. *Id.* at 4898, 4902. "[T]he investment adviser of a registered investment company shall be deemed to have a fiduciary duty with

5. At oral argument, plaintiffs' counsel declared the existence of a potential conflict of interest, as opposed to an actual conflict of interest, to be impossible. Congress would disagree.

respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser." ICA § 36(b), 15 U.S.C. § 80a-35(b).

A shareholder in an investment company may bring suit under section 36(b), on behalf of such company, for breach of fiduciary duty in respect of such compensation. *Ibid.* "No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments." 15 U.S.C. § 80a-35(b)(3). In any such action, approval of an investment compensation agreement or arrangement by an investment company's directors, or ratification of such an agreement or arrangement by an investment company's shareholders, "shall be given such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. § 80a-35(b)(2). Any award of damages shall be limited to the actual damages resulting from the breach of fiduciary duty, and shall in no event exceed the amount of compensation or payments received; and no award of damages shall be recoverable for any period prior to one year before the action was instituted. 15 U.S.C. § 80a-35(b)(3). Finally, "plaintiff shall have the burden of proving a breach of fiduciary duty." 15 U.S.C. § 80a-35(b)(1).

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Plaintiffs' Claims under Section 36(b) of the ICA

Plaintiffs expressly stated in their briefs and at oral argument that they do not allege the advisors' compensation was excessive. *E.g.* Pls.' Mem. Supp. Mot. Partial Summ. J. at 4. Rather, plaintiffs allege that taking into account the municipal bonds purchased with the proceeds from sale of preferred stock in determining advisory fees creates an actual conflict of interest between the advisors and the funds; that the advisors' supposed failure adequately to have disclosed this conflict to the funds or their common shareholders amounts to an actionable breach of fiduciary duty; and that the conflict itself is per se an actionable breach of fiduciary duty. *See* Am. Compl. ¶ 95, at 30. Plaintiffs seek to hold the funds, the advisors, and two individual officers of the funds and the advisors, Arthur Zeikel and Terry Glenn (collectively, "the officers"), liable for those advisory fees attributable to the additional municipal bonds purchased with the proceeds from the issuance of preferred stock. Plaintiffs have moved for partial summary judgment establishing the advisors and the officers' liability to the plaintiffs; plaintiffs have conceded that the funds cannot be held liable under section 36(b) of the ICA. Pls.' Opp'n Individual and Fund Defs.' Mots. Summ. J. at 7.

Defendants oppose plaintiffs' motion, and move for summary judgment in their favor. Defendants contend that plaintiffs lack constitutional and statutory standing to press their claims; that plaintiffs have misconstrued section 36(b) of the ICA; that there was no failure adequately to disclose the method of calculating the advisors' fees; that the officers cannot be held liable to the plaintiffs because they did not

receive compensation or payments from the funds; and that the advisors did not breach their fiduciary duty to the funds and their shareholders. These contentions shall be addressed seriatim.

Standing

The issue of standing, at least in its constitutional dimension, must be considered before assaying the merits ofthe parties' motions for summary judgment. *Steel Co. v. Citizens for a Better Env't*, 523 U.S. 83, 93-102, 118 S. Ct. 1003, 1012-16, 140 L. Ed. 2d 210 (1998). "[T]he core component of standing is an essential and unchanging part of the case-or- controversy requirement of Article III [of the United States Constitution]." *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 560, 112 S. Ct. 2130, 2136, 119 L. Ed. 2d 351 (1992). The irreducible constitutional minimum of standing contains three elements: injury in fact, causation, and redressability. *Lujan*, 112 S. Ct. at 2136. Injury in fact is an invasion of a legally protected interest that is concrete and particularized, and actual or imminent. *Ibid.* Causation means that the injury complained of is fairly traceable to the defendant's conduct. *Ibid.* Redressability means that the injury will likely be remedied by a favorable decision. *Ibid.*

Defendants contend that plaintiffs lack constitutional standing to press their claims because they have not alleged, and cannot prove, actual injury. More specifically, defendants contend that because the plaintiffs have seen positive — and, in defendants' words, handsome-overall returns and yields on their investments in the funds from 1995 through the present, plaintiffs have suffered no damage, and cannot complain about the payment of advisory fees.

Defendants' contention is unavailing. Irrespective of how well (or, at certain times, how poorly) the funds have performed for the common shareholders, it is clear that plaintiffs will be entitled to recover at least some of the advisory fees if those fees were paid to the advisors in violation of the advisors' fiduciary duty to the funds and their shareholders, and if the plaintiffs can meet the other conditions set forth in section 36(b) of the ICA. Though statutory standing and constitutional standing are separate doctrines, here they are coextensive. Plaintiffs have, in the first instance, the legal right to recover from investment advisors whose compensation violates the advisors' fiduciary duty to the funds and their shareholders. If plaintiffs were to meet their burden of showing a breach of fiduciary duty (the contours of which will be limned shortly), it would flow that at least some, if not all, of the advisory fees would be recoverable under section 36(b). *See Green*, 19 F. Supp. 2d at 235. Thus, the injury would be fairly traceable to the advisors' conduct, and would be remedied by an award of money damages under section 36(b). The plaintiffs have standing to press their claims.

Summary Judgment

A motion for summary judgment shall be granted only if there is "no genuine issue as to any material fact and . . . the moving party is entitled to a judgment as a matter of law." FED. R. CIV. P. 56(c). Material facts are those that might affect the outcome of the suit under the governing law. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248, 106 S. Ct. 2505, 2510, 91 L. Ed. 2d 202 (1986). A genuine issue exists if the record taken as a whole could lead a rational trier of fact to find for

the party opposing summary judgment. *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 587, 106 S. Ct. 1348, 1356, 89 L. Ed. 2d 538 (1986).

In disposing of a motion for summary judgment, it is not the province of the trial court to weigh the evidence and to decide the case on its merits; rather, the trial court shall simply determine whether there is a genuine issue for trial. *Anderson*, 477 U.S. at 249, 106 S. Ct. at 2511. In determining whether there is a genuine issue for trial, the trial court must take the nonmovant's allegations of fact as true, *Goodman v. Mead Johnson & Co.*, 534 F.2d 566, 573 (3rd Cir. 1976), and resolve all doubts and make all reasonable inferences in the nonmovant's favor, *Apalucci v. Agora Syndicate, Inc.*, 145 F.3d 630, 631 (3rd Cir. 1998). Credibility determinations are not to be made on motions for summary judgment. *Abraham v. Raso*, 183 F.3d 279, 287, 294 (3rd Cir. 1999).

These standards for disposing of a motion for summary judgment remain unchanged when a court is faced with cross-motions for summary judgment. *Appelmans v. City of Phila.*, 826 F.2d 214, 216 (3rd Cir. 1987). However, if review of cross-motions for summary judgment reveals no genuine issue of material fact, then judgment may be entered in favor of the party deserving of judgment under the law and the undisputed facts. *Iberia Foods Corp. v. Romeo Jr.*, 150 F.3d 298, 302 (3rd Cir. 1998).

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Construction of Section 36(b) of the ICA

Defendants claim the plaintiffs have misconstrued section 36(b) of the ICA. They are correct. Both in their briefs and at oral argument, plaintiffs repeatedly asserted that this court found and held in *Green* that the advisors had breached their fiduciary duty to the funds and their shareholders, and that it therefore somehow devolved upon the defendants to justify their actions. This is lawyerly embroidery upon the fabric of a published judicial decision. Nowhere in *Green* did this court reallocate the traditional burdens of production and persuasion; nowhere in *Green* did this court reallocate the specific, express burden imposed upon the plaintiffs by section 36(b) of proving a breach of fiduciary duty; and nowhere in *Green* did this court find or hold that any defendant had indeed breached a fiduciary duty. In fabricating this assertion out of whole cloth, plaintiffs ignore the plain language of section 36(b): "plaintiff shall have the burden of proving a breach of fiduciary duty." 15 U.S.C. § 80a-35(b)(1).

Plaintiffs have further misconstrued section 36(b) of the ICA in assuming that state-law fiduciary-duty doctrines developed in the areas of corporate law and trusts have been incorporated or imported into section 36(b). This is not so. As a matter of federal statutory law, Congress has declared in section 36(b) that investment company advisors owe shareholders in investment companies a fiduciary duty in determining and receiving their advisory fees. Though the scope and particulars of this duty will of course be fleshed out by the courts as they develop federal common law on this subject, the fiduciary duty imposed upon investment

advisors by section 36(b) is not inflected by state corporate or trust law. *See Tannenbaum v. Zeller*, 552 F.2d 402, 416 (2nd Cir. 1977), *cited and followed in Verkouteren v. Blackrock Fin. Mgmt., Inc.*, 37 F. Supp. 2d 256, 261 (S.D.N.Y. 1999).[6]

Disclosure of Method of Calculating Advisory Fees

Plaintiffs allege that the advisors have breached their fiduciary duty to the funds and their shareholders by failing adequately to disclose that the municipal bonds purchased with the proceeds from the funds' issuance of preferred stock are taken into account as assets in determining the advisory

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6. It is true that section 36(b) was "not designed to ignore concepts developed by the courts as to the authority and responsibility of directors." S. REP. No. 91-547, *reprinted in* 1970 USSCAN 4897, 4903. The remainder of this passage makes it clear, however, that section 36(b) was designed to strengthen the ability of unaffiliated directors to gauge the propriety of advisory conduct, "and to provide a means by which the Federal courts can effectively enforce the **federally-created fiduciary duty** with respect to management compensation." *Ibid.* (emphasis added). Section 36(b) was "not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary," *ibid.*, and "was not enacted to provide a cause of action . . . to govern the directors' independence or the investment adviser's general performance." *Migdal v. Rowe Price-Fleming Int'l Inc.*, 2001 WL 460752, at *4 (4th Cir. May 1, 2001).

Taken in context, then, this statement from the legislative history of section 36(b) means that the courts are not charged with the task of managing investment companies; it does not mean that Congress intended to incorporate state-law fiduciary-duty precepts into section 36(b).

fees. This allegation is frivolous. The prospectus specifies that the funds will pay the advisors for their investment management services a monthly fee of one-half of one percent (0.50%) of the funds' average weekly net assets. Prospectus, Ex. B to Murphy Decl., at 22. The prospectus then immediately defines average weekly net assets as "the average weekly value of the **total assets of the fund,** minus the sum of accrued liabilities of the fund and accumulated dividends on the shares of preferred stock." Prospectus at 22 (initial capital omitted, emphasis added). "Total" means "comprising or constituting a whole; entire; absolute, utter." WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 1246 (1983). The phrase "total assets of the fund" is susceptible of only one reading: it means **all** the assets of the fund, including, of course, those municipal bonds purchased with the proceeds from the funds' issuance of preferred stock. That the investment advisory agreement contains additional language, *see supra* pages 8-9, is of no moment; the meaning of the word "total" is nose-face plain.

The Officers Cannot Be Held Liable under Section 36(b) of the ICA

Defendants have submitted the sworn declaration of Donald C. Burke ("Burke"), First Vice-President of Merrill Lynch Investment Managers and Treasurer of the funds, in which he states that the officers received no payments or compensation from the funds from 1994 through 1996. Burke Decl., 2/5/01, ¶ 3, at 2. Defendants further stated at oral argument that the officers have never received payment or compensation from the funds. Though plaintiffs nominally dispute this sworn allegation, *see* Pls.' Resp. Defs.' Statement

Material Facts ¶ 28, at 19-20, in reality their disputation is purely legal: because the officers received salary payments from the funds, plaintiffs argue, the officers indirectly received advisory compensation recoverable under section 36(b) of the ICA.

Congress took great pains to specify who may be held liable and from whom damages may be recovered under section 36(b). "No such action shall be brought or maintained against any person other than the recipient of such [advisory] compensation or payments [of a material nature], and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments." 15 U.S.C. § 80a-35(b)(3). Though recovery may be had from affiliates of investment advisors, *see* 15 U.S.C. § 80a-35(b), "[t]his provision affords a remedy if the investment adviser should try to evade liability by arranging for payments to be made not to the adviser itself but to an affiliated person of the adviser." S. REP. No. 91-184 (1970), *reprinted in* 1970 USSCAN 4897, 4910-11. Plaintiffs do not allege that the advisors have tried to evade liability under section 36(b) by arranging for advisory fees to be paid to the officers instead of the advisors; plaintiffs simply allege that the officers must have received advisory compensation or payments of a material nature because they were paid salaries by the advisors. As a matter of law, this is insufficient to make the officers recipients of compensation or payments so as to subject them to liability under section 36(b). *See Tarlov v. Paine Webber Cashfund, Inc.*, 559 F. Supp. 429, 441 (D. Conn. 1983) (construing recipiency strictly under § 36(b), and dismissing pendent state-law claims against investment funds and their affiliated and independent directors because those parties could not be held liable under § 36(b)).

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The Advisors Did Not Breach Their Fiduciary Duty to the Funds or to the Shareholders

As noted above, *see supra* pages 13-14, the federally created fiduciary duty imposed by Congress upon investment advisors in section 36(b) is not imbued by state corporate-law or trust-law fiduciary-duty doctrine. It remains to describe the advisors' fiduciary duty to the funds and their shareholders concerning advisory fees, and to determine whether the advisors' collected their fees in violation of that duty.

The paradigmatic claim under section 36(b) is for recovery of excessive advisory fees. Indeed, the United States Courts of Appeals for the Second Circuit and the Fourth Circuit limit section 36(b) claims to those for recovery of excessive fees, and predicate recovery upon a showing that an investment advisor received a fee "so disproportionately large that it bears no reasonable relationship to the [advisory] services rendered and could not have been the product of arm's-length bargaining." *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2nd Cir. 1982), *quoted and followed in Migdal*, 2001 WL 460752, at *2, *4-*5. This court, by contrast, took a broader view in *Green*, and held that section 36(b) "is not expressly limited to situations in which the advisory fees received by an investment adviser were excessive, disproportionate or otherwise unreasonable." *Green*, 19 F. Supp. 2d at 234 (declining to follow *Gartenberg*), *quoted and followed in Krantz v. Prudential Investments Fund Mgmt. LLC*, 77 F. Supp. 2d 559, 565 (D.N.J. 1999) (*per* Hayden, J.), *and followed in Green v. Nuveen Advisory Corp.*, 186 F.R.D. 486, 491 (N.D. Ill. 1999).[7]

7. The plaintiff in the instant case, Jack Green, is the plaintiff in *Green v. Nuveen Advisory Corp.* Accordingly, that case shall hereinafter be cited as "*Nuveen.*"

Therefore, plaintiffs' waiver of a claim against the advisors for excessive fees does not preclude the possibility of plaintiffs' prevailing under section 36(b).

Plaintiffs argue that the advisors' failure ever to have "deleveraged" the funds, i.e. to have sold municipal bonds in order to redeem shares of preferred stock in times of high short-term or long-term interest rates, means the advisors have mismanaged the funds and received fees on too great a corpus of assets. But plaintiffs have expressly waived any claim that the advisors' fees were excessive; and to the extent they allege mismanagement, their claim is not cognizable under section 36(b). *Migdal*, 2001 WL 460752, at *4, *quoted supra* note 6.

Plaintiffs' sole remaining refuge is the argument that the advisors received their compensation from the funds in the face of an actual conflict between their interests and the funds and shareholders' interests that is a per se breach of fiduciary duty. This argument fails.

Plaintiffs do not dispute that "virtually all of the more than 200 tax-exempt leveraged closed-end bond funds that leverage using preferred stock calculate their fees based on net assets, including the assets purchased with the proceeds from the sales of preferred stock." Defs.' Statement Undisputed Material Facts ¶ 45, at 10-11; Pls.' Resp. Defs.' Statement Undisputed Material Facts ¶ 45, at 24. If the potential conflict between the advisors' interest and the funds and shareholders' interests that motivated Congress to enact the carefully calibrated provisions of section 36(b) automatically rose per se to the level of a breach of fiduciary

duty, then every investment advisory compensation agreement or arrangement would be invalid. Surely Congress did not intend this absurd result.

Even if basing the advisors' fees upon the funds' total assets (including by definition the municipal bonds purchased with the proceeds from the funds' issuance of preferred stock) brings the advisors' interests into actual conflict with the funds and shareholders' interests, this alone, without more, is not per se a breach of fiduciary duty. Though there are no cases directly in point decided under the ICA, instructive and persuasive in this regard is *Friend v. Sanwa Bank Cal.*, 35 F.3d 466 (9th Cir. 1994), decided under the Employee Retirement Insurance Security Act of 1974 ("ERISA"). Section 404(a)(1)(A)(i) of ERISA requires the fiduciary of an employee welfare or pension benefit plan to "discharge his duties with respect to a plan solely in the interest of the [plan] participants and beneficiaries and . . . for the exclusive purpose of providing benefits to participants and their beneficiaries." ERISA § 404(a)(1)(A)(i), 29 U.S.C. § 1104(a)(1)(A)(i) (1974, as amended), *quoted in Friend*, 35 F.3d at 468. Though the language of section 404(a) of ERISA apodictically imposes upon plan fiduciaries an express fiduciary duty of undivided loyalty to plan participants and beneficiaries — an express fiduciary duty not imposed upon investment advisors by section 36(b) of the ICA — the United States Court of Appeals for the Ninth Circuit, speaking through Judge O'Scannlain, held that a fiduciary bank "does not commit a per se violation of section 1104(a)(1) by the mere act of becoming a trustee with conflicting interests." *Friend*, 35 F.3d at 469. If an actual conflict of interest does not per se amount to a breach of the

express fiduciary duty of undivided loyalty imposed by ERISA, then *a fortiori* an actual conflict between the advisors' interests and the funds and shareholders' interests does not per se amount to a breach of the more generic fiduciary duty imposed by the ICA.

Plaintiffs' also do not dispute that each year since the funds were created, their boards of directors, including the disinterested directors required under the ICA to sit on those boards,[8] have reconsidered and approved the funds' advisory compensation agreements. Pls.' Statement Undisputed Material Facts ¶ 49, at 11; Defs.' Resp. Pls.' Statement Undisputed Material Facts ¶ 49, at 25. The approval of an investment compensation agreement or arrangement by an investment company's directors "shall be given such consideration by the court as is deemed appropriate under all the circumstances," 15 U.S.C. § 80a 35(b)(2). In this case, such undisputed approval militates strongly against the contention that the advisors have breached their fiduciary duty to the funds or their shareholders.[9]

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8. *See Migdal*, 2001 WL 460752, at *5 (providing a succinct yet complete explanation of the various provisions of the ICA governing disinterested directorships).

9. Plaintiffs' contention that taking total assets into account in determining advisory fees creates an unhealthy, self-directed incentive in the advisors to maintain maximum leverage on the funds' assets, and so results in a breach of fiduciary duty or an actual conflict of interest, is further undermined by the plaintiffs' failure to allege violation of the provisions of the ICA requiring asset coverage of at least two hundred percent (200%) when the preferred stock (a "senior security" under the ICA) is issued, sold, or is to pay a dividend to preferred shareholders. *See* 15 U.S.C. § 80a-18(a)(2)(A), (B), (b).

In sum, under the law and on the undisputed facts, plaintiffs have not met and cannot meet their burden under section 36(b)(1) of proving the breach of a fiduciary duty. As plaintiffs have no arrows left in their quiver,[10] summary judgment shall be granted in favor of the defendants on plaintiffs' claim under section 36(b) of the ICA.

Dismissal of the State-Law Claims

This court may decline to exercise supplemental jurisdiction over the state-law claims recently reinstated by the United States Court of Appeals for the Third Circuit where it has dismissed all claims over which it has original jurisdiction. 28 U.S.C. § 1367(c)(3) (1990). This court's rendition of summary judgment in defendants' favor on plaintiffs' claim under section 36(b) of the ICA — the sole remaining claim over which this court had original jurisdiction under 28 U.S.C. § 1331 — amounts to a dismissal under section 1367(c)(3). *See Hedges v. Musco*, 204 F.3d 109, 112, 122-24 (3rd Cir. 2000). Indeed, under binding Third Circuit precedent, this court must decline to exercise supplemental jurisdiction over the plaintiffs' state common-law claims for breach of fiduciary duty and deceit "unless considerations of judicial economy, convenience, and fairness to the parties provide an affirmative justification for doing

10. Plaintiffs sketched the outline of a claim in their amended complaint against defendant Merrill Lynch, Pierce, Fenner & Smith, Inc., who they allege received service fees and "collateral revenues" from the weekly auctions of issued preferred stock in violation of section 36(b). Plaintiffs made no mention of this adumbrated claim in their briefs or at oral argument. These fees are neither compensation nor payments of a material nature under section 36(b), and so cannot be recovered thereunder. *Nuveen*, 186 F.R.D. at 492.

so." *Hedges*, 204 F.3d at 123 (quoting *Borough of W. Mifflin v. Lancaster*, 45 F.3d 780, 788 (3rd Cir. 1995)). No such considerations inhere in this case. It is distinctly possible that Maryland state law may govern these state-law claims; *see* Prospectus, Ex. B. to Murphy Decl., at 35 (adverting to advice of counsel on matters of Maryland law). The plaintiffs may therefore wish to file a new complaint alleging breach of fiduciary duty and deceit in a Maryland state court; certainly, this court is not expert in matters of Maryland law. Regardless of where plaintiffs file a new complaint if they choose to do so, their claims will not be time-barred, for any applicable state statutes of limitation have been tolled during the pendency of this case and will be tolled for thirty (30) days after the claims have been dismissed by this court (unless applicable state law provides a longer period). 28 U.S.C. § 1367(d), *discussed in Hedges*, 204 F.3d at 123-24. If plaintiffs wish to pursue their state-law claims against the defendants, they must do so in state court.

CONCLUSION

In *Green*, this court declined to grant judgment on the pleadings on plaintiffs' claim under section 36(b) of the Investment Company Act of 1940 because determining whether the advisors' fee arrangement constitutes a per se breach of fiduciary duty required "an exploration of the economic realities of [the] funds and market circumstances and practices." *Green*, 19 F. Supp. 2d at 235. The court awaited the making of a record "either on a summary judgment motion or at a trial." *Ibid.* Based on the law, and on the undisputed facts developed on this record, plaintiffs cannot prevail on their claim under section 36(b) of the ICA.

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Summary judgment shall therefore be entered in the defendants' favor, and the plaintiffs' remaining state-law claims shall be dismissed. An appropriate order shall enter.

An appropriate order shall enter.

June 5, 2001

s/ Dickinson R. Debevoise
DICKINSON R. DEBEVOISE
U.S.S.D.J.

Appendix B

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

C.A. No. 97-3502 (DRD)

JACK GREEN, Individually and as Trustee,
LAWRENCE P. BELDEN, Trustee, and
STANLEY SIMON, Trustee,

Plaintiffs,

v.

FUND ASSET MANAGEMENT, L.P.,
MERRILL LYNCH ASSET MANAGEMENT, L.P.,
MERRILL LYNCH & CO., INC.,
MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,
PRINCETON SERVICES, INC., ARTHUR ZEIKEL,
TERRY K. GLENN, MUNIENHANCED FUND, INC.,
MUNIVEST FUND II, INC., MUNIYIELD FUND, INC.,
MUNIYIELD INSURED FUND, INC.,
MUNIYIELD INSURED FUND II, INC.,
MUNIYIELD QUALITY FUND, INC., and
MUNIYIELD QUALITY FUND II, INC.,

Defendants.

ORDER

This matter having come before the court on defendants' motions for summary judgment on plaintiff's claim under section 36(b) of the Investment Company Act of 1940, as amended, and on plaintiffs' cross-motion for partial summary judgment on liability on the same claim, and the court having considered the parties' written submissions and having heard oral argument, and for good cause shown,

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IT IS, on this 5th day of June, 2001, HEREBY ORDERED AS FOLLOWS:

1. Plaintiffs' cross-motion for partial summary judgment shall be and hereby is denied.

2. Defendants' motions for summary judgment shall be and hereby are granted, and plaintiffs' claim under section 36(b) of the Investment Company Act of 1940 (their only remaining federal-law claim) is dismissed.

3. The court declines to exercise its supplemental jurisdiction over the plaintiffs' remaining state-law claims, and dismisses those claims without prejudice to their being refiled in state court.

s/ Dickinson R. Debevoise
DICKINSON R. DEBEVOISE
U.S.S.D.J.

APPENDIX C — OPINION OF THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF NEW JERSEY DATED FEBRUARY 23, 1998

UNITED STATES DISTRICT COURT,
D. NEW JERSEY.

No. Civ. 97-3502 (DRD).

Feb. 23, 1998

Jack GREEN, Individually and as Trustee, Lawrence P. Belden, Trustee, and Stanley Simon, Trustee,

Plaintiffs,

v.

FUND ASSET MANAGEMENT, L.P., Merrill Lynch Asset Management, L.P., Merrill Lynch & Co., Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated, Princeton Services, Inc., Arthur Zeikel, Terry K. Glenn, Munienhanced Fund, Inc., Munivest Fund II, Inc., Muniyield Fund, Inc., Muniyield Insured Fund, Inc., Muniyield Insured Fund II, Inc., Muniyield Quality Fund, Inc., and Muniyield Quality Fund II, Inc.,

Defendants.

* * *

Appendix C

OPINION

DEBEVOISE, Senior District Judge.

The complaint in this action charges that defendants have violated and are violating Sections 8(a), 34(b) and 36(a) and (b) of the Investment Company Act of 1940 and are liable to plaintiffs under state law. Defendants have moved to dismiss the complaint pursuant to Fed.R.Civ.P. 12(b)(6). For the reasons set forth below, the claims asserted under Sections 8(a), 34(b) and 36(a) of the Act will be dismissed, and in all other respects defendants' motion will be denied.

BACKGROUND

Plaintiffs are shareholders in seven investment companies which are the named defendants in this action, MuniEnhanced Fund, Inc., MuniVest Fund II, Inc., MuniYield Fund, Inc., MuniYield Insured Fund, Inc., MuniYield Insured Fund II, Inc., MuniYield Quality Fund, Inc., and MuniYield Quality Fund II, Inc. (the "Funds"). Plaintiffs invested a total of more than $44,000.00 in the Funds between May 22 and October 18, 1995. Jack Green has brought suit individually and in his capacity as a trustee of seven trusts that invested in the Funds. The other two plaintiffs, Lawrence P. Belden and Stanley Simon, sue solely as trustees of trusts that invested in the Funds.[1]

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1. Although they are not named in the caption, the complaint also identifies as plaintiffs seven trusts that allegedly purchased shares of the Funds. Plaintiffs have brought their case as a putative class action, seeking to represent more than 100,000 investors in the Funds.

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The Funds are closed-end investment companies that are registered with the Securities and Exchange Commission ("SEC") under the Federal securities laws and publicly traded on the New York Stock Exchange. All of the Funds are incorporated under the laws of Maryland and have their principal places of business in Plainsboro, New Jersey. The Funds' goal is to provide shareholders with income exempt from Federal income taxes by investing in long- term tax-exempt municipal bonds. The Funds attempt to increase the yields paid to their common stockholders through the use of leverage. The Funds leverage by issuing shares of preferred stock that pay dividends based upon prevailing short-term interest rates and investing the proceeds from the sales of the preferred stock in longer-term obligations that, under normal market conditions, pay higher rates. The spread between the short-term rates paid by the Funds to holders of the preferred stock and the longer-term rates received by the Funds provides holders of the common stock with a potentially higher yield.

Defendant Fund Asset Management, L.P. ("FAM") serves as the Funds' investment adviser and is responsible for managing the Funds' investment portfolios and providing administrative services to the Funds. Pursuant to written investment advisory agreements, the Funds pay FAM a fee for its services based upon a percentage of their weekly net assets. The MuniEnhanced Fund, Inc. prospectus discloses the advisory fee as follows:

For the services provided by the Investment Adviser [FAM] under the Investment Advisory Agreement, the Fund will pay a monthly fee at an annual rate of .50 of 1% of the

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Fund's average weekly net assets (*i.e.*, the average weekly value of the total assets of the Fund, minus the sum of accrued liabilities of the Fund and accumulated dividends on the shares of preferred stock). For purposes of this calculation, average weekly net assets is determined at the end of each month on the basis of the average net assets of the Fund for each week during the month. Compl. Ex. A, Tab 1 at page 20.[2]

Defendant Merrill Lynch Asset Management, L.P. ("MLAM") is an affiliate of FAM. MLAM and FAM are organized under the laws of Delaware and have their principal places of business in Plainsboro, New Jersey. Defendant Princeton Services, Inc. ("PSI"), a Delaware corporation with its principal place of business in Plainsboro, New Jersey, is the general partner of FAM and MLAM. PSI has a 1% interest in FAM and MLAM. Defendant Merrill Lynch and Co., Inc. ("ML & Co.") is FAM's and MLAM's sole limited partner and has a 99% interest in FAM and MLAM. ML & Co. is a publicly traded holding company that, through its subsidiaries and affiliates, provides investment, financing, insurance and related services on a global basis. ML & Co. is a Delaware corporation and maintains its corporate headquarters in New York City.

Defendant Arthur Zeikel is the President and a director of each of the Funds, President and Chief Investment Officer of MLAM and FAM, President and a director of PSI, and an Executive Vice President of ML & Co. Defendant Terry Glenn

2. The prospectuses for the other Funds contain virtually identical disclosures. See Compl. Ex. A, Tabs 2-7.

is the Executive Vice President of each of the Funds and Executive Vice President of FAM and MLAM.

Defendant Merrill Lynch, Pierce, Fenner & Smith Incorporated ("MLPF & S"), a securities broker-dealer and investment bank, served as the principal underwriter for the offerings of the Funds' common stock. MLPF & S also has entered into auction agent agreements with the Funds to sell the Funds' preferred stock. The 1994 MuniYield Insured Fund, Inc. annual statement discloses the fees generated by the preferred stock auctions as follows:

The Fund pays commissions to certain broker-dealers at the end of each auction at an annual rate ranging from 0.25% to 0.375%, calculated on the proceeds of each auction. For the year ended October 31, 1994, MLPF & S, an affiliate of FAMI [FAM's predecessor], received $591,736 as commissions. Moyle Decl., Tab A at 16.[3]

A wholly owned subsidiary of ML & Co., MLPF & S is a Delaware corporation and maintains its corporate headquarters in New York City. Plaintiffs brought this action to redress alleged violations of Sections 8(e), 34(b) and 36(a) and (b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.* ("ICA"). In their complaint, plaintiffs claim that defendants breached their disclosure obligations and fiduciary duties under the ICA and state law.[4]

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3. Each of the Funds' annual statements contains virtually identical disclosures. *See* Moyle Decl., Tabs B-H.

4. Plaintiffs filed their complaint in the United States District Court for the District of Massachusetts on June 21, 1996. Defendants (Cont'd)

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Plaintiffs allege that defendants "failed to explicitly or-sufficiently disclose" that the calculation of FAM's management fee would include assets purchased with the proceeds from sales of the preferred stock. Compl. ¶ 63(1). They claim that because the advisory fee is measured as a percentage of all of the Funds' capitalization, including leverage, there is a strong financial incentive for FAM to keep the Funds fully leveraged at all times, even when it would be in the best interest of the investors to reduce or eliminate leverage.[5] They allege that the fee arrangement creates an inherent conflict of interest which was undisclosed in the Funds' prospectuses, filings with the SEC and its periodic reports to the shareholders. Compl. ¶ 63(2), (4). Plaintiffs also allege that defendants failed to disclose that the decision to issue preferred stock was subject to a conflict of interest because FAM's affiliate, MLPF & S, received fees from the sales of preferred stock. Compl. ¶ 63(3). In addition, they claim that defendants have continually misled investors as to the level of expense charged to the Funds, common stockholders. Compl. ¶ 68.

Plaintiffs seek compensatory damages and injunctive relief. They ask for an order permanently restraining and enjoining defendants from entering into any compensation arrangement between the Funds and any investment adviser

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moved to transfer venue to this District pursuant to 28 U.S.C. § 1404. On June 10, 1997, the Magistrate Judge granted defendants' motion. On July 15, 1997, the District Judge affirmed and ordered the transfer.

5. Plaintiffs assert that FAM would lose approximately one-third of its advisory compensation if it eliminated leverage.

under which "the compensation payable to such investment advisor is determined by, dependent upon, or measured or influenced by, the amount of financial leverage of its common equity investment maintained by such fund." Compl., Prayer for Relief ¶ 3.

DISMISSAL PURSUANT TO RULE 12(b)(6)

A complaint must be dismissed pursuant to Fed.R.Civ.P. 12(b)(6) for failure to state a claim upon which relief can be granted if the court finds "beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45-46, 78 S.Ct. 99, 2 L.Ed.2d 80 (1957). In analyzing motions to dismiss, all allegations set forth in the complaint must be accepted as true and all reasonable inferences must be drawn in the plaintiff's favor. *Schrob v. Catterson*, 948 F.2d 1402, 1405 (3d Cir. 1991). A court should allow a plaintiff to amend the complaint instead of dismissing it where "a more carefully drafted complaint might state a claim upon which relief could be granted." *Friedlander v. Nims*, 755 F.2d 810, 813 (11th Cir. 1985); *see Howze v. Jones & Laughlin Steel Corp.*, 750 F.2d 1208, 1212 (3d Cir. 1984).

A motion to dismiss which presents the court with matters outside the pleading which are not excluded is to be treated as a motion for summary judgment and analyzed pursuant to Rule 56. Fed.R.Civ.P. 12. In such circumstances, "all parties shall be given reasonable opportunity to present all material made pertinent to such a motion by Rule 56." *Id.* However, undisputedly authentic documents upon which the plaintiff's claims are based may be considered without

converting a motion to dismiss to a motion for summary judgment. *Pension Ben. Guar. Corp. v. White Consol. Indus., Inc.*, 998 F.2d 1192, 1196 (3d Cir. 1993), *cert. denied*, 510 U.S. 1042, 114 S.Ct. 687, 126 L.Ed.2d 655 (1994); *In re Westinghouse Securities Litig.*, 90 F.3d 696, 707 (3d Cir. 1996).

ANALYSIS

Defendants move to dismiss the complaint in its entirety on the following grounds: 1) plaintiffs' claims under Sections 8(e), 34(b) and 36(a) are time-barred; 2) all material facts concerning the compensation arrangements between the Funds and FAM were adequately disclosed by defendants; 3) plaintiffs' breach of fiduciary duty claim under Section 36(a) was improperly brought directly rather than derivatively on behalf of the Funds; 4) plaintiffs fail to state a claim under Section 36(b) of the ICA, 15 U.S.C. § 80a-35(b), because they do not allege that FAM's advisory fees are excessive or disproportionate to the services rendered; and 5) as plaintiffs have no federal claims under the ICA, supplemental jurisdiction should not be exercised over the state law claims.

I. Defendants' Motion to Dismiss Plaintiffs' Claims Brought Pursuant to Sections 8(e), 34(b) and 36(a) of the ICA

Defendants argue that plaintiffs' claims under Sections 8(e), 34(b) and 36(a) of the ICA are time-barred. They contend that the applicable statute of limitations for these claims is one year from the date a plaintiff discovered or reasonably should have discovered the alleged

misrepresentations or omissions, with an absolute limit of three years from the date an allegedly misleading document is filed with the SEC.

Plaintiffs argue that their claims are timely because the applicable limitations period should not be the one-year/three-year period advanced by defendants, but rather, the five-year limitations period for actions brought by the SEC under Section 36(a) of the ICA. Plaintiffs also assert that the limitations period for their state law breach of fiduciary duty claims should apply in the event the Court finds the five-year period is inapplicable. In the alternative, they argue that even if the one-year/three-year period applies, their complaint is nevertheless timely because their claims accrued when they purchased their shares in the Funds, not when the registration statements and prospectuses were filed with the SEC. In addition, plaintiffs maintain that their claims are timely because defendants committed continuing violations of the ICA through their failure to disclose, the alleged conflict of interest in reports to shareholders filed within and subsequent to the three-year period prior to the commencement of this action.

Section 8(e) of the ICA, entitled "Failure to file registration statement or omissions of material fact," provides in pertinent part:

> If it appears to the Commission that a registered investment company has . . . filed such a registration statement or report but omitted therefrom material facts required to be stated therein, . . . the Commission shall notify such

> company by registered mail or certified mail of the . . . respects in which such registration statement or report appears to be materially incomplete or misleading. . . . If such registration statement or report is not filed or corrected within the time so fixed by the Commission or any extension thereof, the Commission, after appropriate notice and opportunity for hearing, . . . may by order suspend the registration of such company until such statement or report is filed or corrected, or may by order revoke such registration. . . .

15 U.S.C. § 80a-8(e). Section 34(b) of the ICA provides:

> It shall be unlawful for any person to make any untrue statement of a material fact in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to this Act or the keeping of which is required pursuant to section 31(a). It shall be unlawful for any person so filing, transmitting, or keeping any such document to omit to state therein any fact necessary in order to prevent the statements made therein, in the light of the circumstances under which they were made, from being materially misleading.

15 U.S.C. § 80a-33(b). Section 36(a) of the ICA, 15 U.S.C. § 80a-35(a), authorizes the SEC to bring an action to enjoin "any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company."

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The foregoing sections of the ICA do not expressly provide for a private right of action and thus, do not contain an express statute of limitations for such actions. Section 36(a), however, authorizes the SEC to commence an action within five years of a violation of that provision, which protects against breach of fiduciary duty arising out of the personal misconduct of directors or investment advisers of a mutual fund. Plaintiffs argue that this five-year limitations period is applicable to their claims, citing *Lampf v. Gilbertson*, 501 U.S. 350, 111 S.Ct. 2773, 115 L.Ed.2d 321 (1991), in which the Supreme Court stated that where the claim asserted is "one implied under a statute that also contains an express cause of action with its own time limitation, a court should look first to the statute of origin to ascertain the proper limitations period." *Id.* 501 U.S. at 359, 111 S.Ct. 2773. Defendants argue that the five-year limitations period is inapplicable. They contend that the precise argument plaintiffs have asserted here has been rejected time and again by courts which have considered this issue.

Assuming that plaintiffs have an implied right of action under the provisions of the ICA referred to above, it is necessary to consider whether the five-year limitations period should apply to their claims in accordance with *Lampf*.[6]

6. It is noted that there is authority recognizing the existence of an implied private right of action under Section 36(a) of the ICA. *See In re ML-Lee Acquisition Fund II, L.P.*, 848 F.Supp. 527, 542 (D.Del. 1994). In addition, the Third Circuit Court of Appeals has stated that as a general matter private rights of action should be implied under the ICA. *Bancroft Convertible Fund v. Zico Inv.*

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Pertinent and persuasive case law suggests that their claims must be dismissed as time-barred.

Plaintiffs have not cited and research has not revealed a case in which a court which recognized an implied right of action under the ICA applied the five-year limitations period for claims brought by the SEC under Section 36(a). The courts which have considered the issue have uniformly applied the one-year/three-year limitations period for claims under the Securities Exchange Acts of 1933 and 1934 to implied rights of action under the ICA. *See Blatt v. Merrill Lynch*, 916 F.Supp. 1343, 1351 (D.N.J. 1996) (applying the one-year/three-year limitations period to claims under Section 7(d) of the ICA); *Friedlob v. Trustees of Alpine Mutual Fund Trust*, 905 F.Supp. 843, 855-56 (D.Colo. 1995) (applying one-year/three-year limitations period to claims under Sections 8, 13, 15, 17 and 21 of the ICA); *Merine v. Prudential-Bache Utility Fund, Inc.*, 859 F.Supp. 715, 721-22 (S.D.N.Y. 1994) (applying the one-year/three-year limitations period to a claim under Section 20(a) of the ICA); *In re ML-Lee*, 848 F.Supp. at 551 (applying the one-year/three-year limitations period to claims under Sections 17, 36(a) and 57 of the ICA); *In re Taxable Municipal Bond Securities Litig.*, 1992 WL 124783, at *3 (E.D.La. June 4, 1992) (applying one-year/three-year limitations period to claims under Sections 7 and 8 of the ICA), *aff'd*, 964 F.2d 1144 (5th Cir. 1992).

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Holdings, 825 F.2d 731, 733-36 (3d Cir.1987) (considering whether private rights of action should be implied under the ICA and concluding that a private right of action should be implied under Section 12(d)(1)(a)).

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The reasoning of the foregoing cases is persuasive, and it is likely that the Court of Appeals in this circuit would hold that the one-year/three-year limitations period is applicable to plaintiffs' claims under Sections 8(e), 34(b) and 36(a). Plaintiffs argue that even if this period applies, their claims are timely because they accrued at the time they purchased their securities as would be the case with claims brought under Rule 10b-5. Claims of non-disclosure under Section 8(e), 34(b) and 36(a), however, are akin to false registration claims under Section 11 of the 1933 Act, as distinguished from claims for misrepresentations in connection with the purchase or sale of a security. The limitations period for Section 11 claims is found in Section 13 of the 1933 Act which provides:

> No action shall be maintained to enforce any liability created under section [11 or 12(2)] of this title unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence . . . *In no event shall any such action be brought to enforce a liability created under section* [11 or 12(1)] *of this title more than three years after the security was bona fide offered to the public* or under section [12(2)] of this title[,] more than three years after sale.

15 U.S.C. § 77m (emphasis added).[7]

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7. A similar limitations provision is found in Section 9(e) the 1934 Act which provides: "[n]o action shall be maintained to enforce any liability created under this section, unless brought within one

(Cont'd)

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Section 11 claims have a three-year statute of repose which requires that claims concerning false or misleading registration statements be filed within three years from the time the securities were "bona fide offered to the public." *Id.* Securities are deemed to have been "bona fide offered to the public" on the effective date of the registration statement. *Finkel v. Stratton Corp.*, 962 F.2d 169, 173 (2d Cir. 1992) (citing *Morse v. Peat, Marwick, Mitchell & Co.*, 445 F.Supp. 619, 622-24 (S.D.N.Y. 1977)); *see also Laven v. Price Waterhouse*, 1989 WL 129287 at *3 (D.N.J. June 28, 1989) (starting date for the three-year repose period for claims alleging omissions in registration statement is the date that the registration statement became effective).

Applying the foregoing analysis here, the most recent of the registration statements in question was filed in February 1992. Plaintiff did not commence this action until June 1996, more than four years later. Thus, plaintiffs' claims under Sections 8(e), 34(b) and 36(a) which concern the prospectuses and registration statements filed with the SEC are untimely under the three-year statute of repose.[8]

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year after the discovery of facts constituting the violation and within three years after such violation." 15 U.S.C. § 78i(e); *see also Lampf*, 501 U.S. at 364 n. 9, 111 S.Ct. 2773 (adopting 9(e) to claims brought under Section 10(b)).

8. Even if plaintiffs were correct that their claims under the ICA are analogous to claims brought under Rule 10b-5, it is questionable whether this would change the outcome. It has been held that Rule 10b-5 claims accrue on "the date a defendant [made] an affirmative representation or, in the case of an omission, upon the date a duty to disclose the withheld information [arose]." *In re Prudential Ins. Co.*, 975 F.Supp. 584, 605 (D.N.J.1996).

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Plaintiffs argue that their claims under Sections 8(e), 34(b) and 36(a) should not be dismissed as untimely because defendants committed continuing violations of these provisions. They assert that defendants failed to adequately disclose FAM's incentive to leverage the Funds in reports to shareholders which were filed within the three-year period prior to the commencement of this action on June 21, 1996. They specifically refer to an October 31, 1994 report of the MuniYield Fund which they assert contains misleading financial information concerning that Fund's expense ratio. Plaintiffs also assert that, since the commencement of this action, reports were issued to the shareholders which contain misleading financial data. Plaintiffs claim that the defendants' reports to shareholders and regular filings with the SEC constitute fresh violations of the ICA.

Plaintiffs characterization the Funds' more recent reports as new violations is unpersuasive. They acknowledge that the true nature of their claims concerns the disclosure of the advisory fee arrangement in the prospectuses and registration statements which were filed with the SEC well over three years ago. To allow plaintiffs to circumvent the three-year repose period due to the existence of subsequent reports which have only a collateral relationship to their non-disclosure claims would conflict with the purpose of the one-year/three-year statutory scheme. *See Lampf*, 501 U.S. at 361, 111 S.Ct. 2773.[9]

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9. The one-year/three-year structure calls for "the inescapable conclusion that Congress did not intend equitable tolling to apply to actions under the securities laws." *Id.*

Moreover, the type of continuing wrong argument which plaintiffs advance here has been rejected by other courts when considering the timeliness of claims involving the registration of securities. *See Blatt*, 916 F.Supp. at 1352 (rejecting argument that continuing failure to register securities tolled the statute of limitations); *see also Seidel v. Lee*, 954 F.Supp. 810, 813-14 (D.Del. 1996); *Slagell v. Bontrager*, 616 F.Supp. 634, 636-37 (W.D.Pa. 1985), *aff'd*, 791 F.2d 921 (3d Cir. 1986). Thus, the allegation that defendants committed a continuing violation of ICA by failing to correct prior misleading statements in subsequent reports is unavailing to toll the statute of limitations. Plaintiffs' claims under Sections 8(e), 34(b) and 36(a) are time-barred and therefore, must be dismissed.

Assuming arguendo that plaintiffs' claims under Sections 8(e), 34(b) and 36(a) of the ICA were timely, these claims could not be asserted in addition to their Section 36(b) claim. While plaintiffs couch their claims in terms of both non-disclosure of the nature of the fee arrangement and breach of fiduciary duty, Section 36(b) expressly provides a right of action to redress breaches of fiduciary duty involving compensation or payments to an investment adviser. Accordingly, there is no need or basis for an implied right of action under Sections 8(e), 34(b) and 36(a) when plaintiffs' grievances fall within the private right of action provided for in Section 36(b). *See Merine*, 859 F.Supp. at 723 (Section 36(b) is the exclusive remedy for allegations concerning excessive advisory fees, requiring dismissal of related claims asserted under other provisions of the ICA) (citing *Krinsk v. Fund Asset Mgmt., Inc.*, 875 F.2d 404, 413 (2d Cir.),

cert. denied, 493 U.S. 919, 110 S.Ct. 281, 107 L.Ed.2d 261 (1989)); *Tarlov v. Paine Webber Cashfund, Inc.*, 559 F.Supp. 429, 437 (D.Conn. 1983) (same).

II. Defendants' Motion to Dismiss Plaintiffs' Claim Under Section 36(b) of the ICA

As noted above, Section 36(b) expressly provides a private right of action to redress breaches of fiduciary duty concerning the compensation paid to investment advisers. Section 36(b) states, in relevant part:

> For purposes of this subsection, *the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature* paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, *or by a security holder of such registered investment company on behalf of such company,* against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, *for breach of fiduciary duty in respect to such compensation or payments* . . .

15 U.S.C. § 80a-35(b) (emphasis added). An action cannot be "brought or maintained against any person other than the recipient of such compensation or payment" and "[n]o award of damages [is] recoverable for any period prior to one year before the action was instituted." 15 U.S.C. § 80a-35(b)(3).

Defendants maintain that plaintiffs' claim under Section 36(b) of the ICA must be dismissed because plaintiffs have failed to allege that the compensation which has actually been paid to FAM was excessive or disproportionate. They note that the Court of Appeals for the Second Circuit has held that a plaintiff must establish that an advisory fee is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining" in order to prevail on a claim under Section 36(b). *Gartenberg v. Merrill Lynch Asset Mgmt.*, 694 F.2d 923, 928 (2d Cir. 1982) (citations omitted), *cert. denied*, 461 U.S. 906, 103 S.Ct. 1877, 76 L.Ed.2d 808 (1983); *see also Krinsk*, 875 F.2d 404.

Plaintiffs concede that they do not allege that the advisory fees which have been paid to FAM to date were excessive or disproportionate. They argue, however, that Section 36(b) does not contain such a requirement. Plaintiffs maintain that Section 36(b) provides for a private cause of action against a fund's adviser predicated upon an allegation of inadequate disclosure concerning the nature of the fee arrangement, citing *Galfand v. Chestnutt Corp.*, 545 F.2d 807 (2d Cir. 1976).[10] They also argue that Section 36(b) provides

10. In *Galfand* the Second Circuit found that an investment adviser violated Section 36(b) by failing to adequately disclose the negative factors associated with a decision to increase the fund's

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a cause of action to challenge the propriety of an advisory fee arrangement.

Section 36(b) of the ICA is not expressly limited to situations in which the advisory fees received by an investment adviser were excessive, disproportionate or otherwise unreasonable.[11] The statute encompasses the receipt of fees by an investment adviser in violation of the adviser's fiduciary duty, as it provides that "[n]o action shall be brought or maintained against any person *other than the recipient of such compensation or payments.*" 15 U.S.C.A. § 80a-35(3) (emphasis added). Moreover, Section 36(b) has been generally interpreted as providing a private right of action to recover excessive compensation paid to investment advisers. *See e.g., Krinsk*, 875 F.2d 404; *Gartenberg*, 694 F.2d 923; *Kalish v. Franklin Advisers, Inc.*, 742 F.Supp. 1222 (S.D.N.Y. 1990), *aff'd*, 928 F.2d 590 (2d Cir.), *cert. denied*, 502 U.S.

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expense ratio, which resulted in an increase in compensation to the adviser. *Id.* 545 F.2d at 812-14. The Second Circuit noted that "Congress, in imposing a fiduciary obligation on investment advisers [under the ICA], plainly intended that their conduct be governed by the traditional rule of undivided loyalty implicit in the fiduciary bond" whereby "a self-dealing fiduciary owes a duty of full disclosure to the beneficiary of his trust." *Id.* 545 F.2d at 811. Thus, under the Investment Company Act an investment adviser is under a duty of full disclosure where there is a possible conflict of interest between the adviser's interests and the interests of the Fund. *Id.* (citing *Fogel v. Chestnutt*, 533 F.2d 731, 745 (2d Cir. 1975)).

11. Of course, when the fees are excessive or disproportionate to the services rendered, this clearly gives rise to a claim for breach of fiduciary duty under Section 36(b).

818, 112 S.Ct. 75, 116 L.Ed.2d 48 (1991). Indeed, even *Galfand* involved a situation where the investment adviser received an increased fee as a direct consequence of his breach of fiduciary duty. *Galfand*, 545 F.2d at 812 (case remanded to the district court with instruction to award damages in the amount that the adviser was unjustly enriched under the voided contract). Thus, the question remains whether plaintiffs can maintain an action under Section 36(b) when they do not allege that FAM has in fact leveraged the Funds in order to collect a higher fee, but rather, claim that FAM failed to disclose its incentive to keep the Funds fully leveraged and challenge the lawfulness of the advisory fee arrangement.

Plaintiffs assert that an advisory fee arrangement such as that in question here, which bases the investment adviser's compensation in part on the amount of preferred stock in the portfolio, creates an inherent conflict of interest which cannot be cured even if adequately disclosed. If plaintiffs are correct, then the fees collected by FAM to date were the result of a breach of fiduciary duty in violation of Section 36(b). It would flow that such fees were excessive and recoverable to the extent permitted under that Section.

Determining whether this kind of fee arrangement constitutes a per se breach of fiduciary duty requires an exploration of the economic realities of such funds and market circumstances and practices. This determination cannot be made on the pleadings. A record will have to be made either on a summary judgment motion or at a trial. It would be inappropriate to dismiss the Section 36(b) claim at this time.

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CONCLUSION

For the reasons set forth above, defendants' motion to dismiss plaintiffs' claims under Sections 8(e), 34(b) and 36(a) of the Investment Company Act of 1940 will be granted and defendants' motion to dismiss plaintiffs' claim under Section 36(b) of that Act and the state law claims will be denied. An appropriate order follows.

APPENDIX D — RELEVANT STATUTES

Investment Company Act of 1940, 15 U.S.C. § 80a-1, *et seq.*

§ 80a-1. Findings and declaration of policy

* * *

(b) Policy

Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 79z-4 of this title, and facts otherwise disclosed and ascertained, it is declared that the national public interest and the interest of investors are adversely affected —

> (2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;

* * *

Appendix D

It is declared that the policy and purposes of this subchapter, in accordance with which the provisions of this subchapter shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.

* * * *

Appendix D

§ 80a-35. Breach of fiduciary duty

* * *

(b) Compensation or payments as basis of fiduciary duty; civil actions by Commission or security holder; burden of proof; judicial consideration of director or shareholder approval; persons liable; extent of liability; exempted transactions; jurisdiction; finding restriction

For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, ... With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

* * * *